



1958

Community Property and Federal Taxes

John Paul Jackson

Follow this and additional works at: <https://scholar.smu.edu/smulr>

Recommended Citation

John Paul Jackson, *Community Property and Federal Taxes*, 12 Sw L.J. 1 (1958)
<https://scholar.smu.edu/smulr/vol12/iss1/1>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

COMMUNITY PROPERTY AND FEDERAL TAXES[†]

by

*John Paul Jackson**

THIS paper will deal with some of the federal tax problems arising under our community property system. The discussion, necessarily, will be limited in scope, and will touch upon some of the more common problems encountered in the tax practice.¹ A brief resume of the origin and nature of our community property system may be helpful as a background.

1. THE CIVIL LAW ORIGIN OF COMMUNITY PROPERTY

The ancient community property marital system stems from the civil and not the common law. The system is older than the common law.² It is accepted by a larger number of people and applies to a larger territory than was ever true of the common law. The system has found special favor with pioneering peoples where the wife ordinarily joins the husband in all of his efforts to gain a livelihood.³

In the United States there are eight traditional community property states—Texas, Louisiana, California, Washington, Arizona, New Mexico, Idaho and Nevada.⁴ While the laws of these eight states have the same basic concept of marital partnership, they do have different histories and do vary in substantial detail. Thus, Lou-

* Attorney at Law, Dallas, Texas.

† This paper is a revision of an earlier paper, "Problems Relating to Community Property," delivered in November 1955 at the Tax Institute of the University of Houston.

¹ The best modern text on community property generally is the two-volume work of de Funiak, *Principles of Community Property* (1943). A valuable, though older, treatise is McKay, *Community Property* (2d ed. 1925). The standard Texas text, though somewhat out of date, is Speer, *Law of Marital Rights in Texas* (1929). An excellent summary of the Texas law on the subject is the Commentary by W. O. Huie, appearing in the preface to volume 13, *Tex. Rev. Civ. Stat. Ann.*

² It is said that the system had its origins in the laws of the Visigoths. After a victory in battle, the women and men together gathered the spoils of victory and shared the loot equally. In their conquest of Spain, they are supposed to have brought into the Spanish Civil Law this concept of equal sharing between man and wife of the accumulations of the marriage.

³ De Funiak, *op. cit. supra* note 1, at 10, 27.

⁴ In the 1940's several states adopted statutory community property systems in order to give their citizens the benefit of split income tax returns. With the adoption of the joint income tax return provisions in 1948, these states repealed their community laws, but the eight original states continued theirs.

isiana derived its system from the civil law of France and from the Napoleonic Code; whereas, Texas derived its system from the Spanish law via Mexico. As the new territories in the Southwest and the Far West were opened up, lawyers of Anglo-Saxon origin, trained in the English common law, pioneered into the frontier country. As these territories assumed statehood, these lawyers had a considerable hand in the writing of the constitutions and statutes of the new states. Many of these pioneer lawyers, trained in eastern schools, became judges and their early decisions materially affected the jurisprudence of their particular state. The result was that much of the common law has found its way, in varying degrees, into the old civil systems,⁵ and, by legislation and judicial decision, the laws of the several community property states differ in important detail. Thus, in California and Washington, income derived from separate property is the separate income of the separate owner; whereas, in Texas and Louisiana, such income is community. Likewise, the New Mexico system is a hybrid and, perhaps, not a true community property system at all. There, while at the husband's death the wife has a vested half interest in the marital accumulations, she, in event of her prior death, has no power of testamentary disposition over her half of the community. In this important respect, the New Mexico law differs from civil law and from the law of the other community property states.

Because of differences in these state laws, this discussion will be confined to the Texas law.

2. THE TEXAS COMMUNITY PROPERTY SYSTEM

As indicated above, Texas derived its community property laws from Spain by way of Mexico. In Texas, the community system was in force while Texas was a Spanish territory; while Texas was a Mexican territory; while Texas was a republic; and constitutional provisions were made therefor when Texas entered the Union.

The basic concept of the Spanish civil law was that upon marriage, unless otherwise agreed,⁶ man and wife became partners in all accumulations during marriage, each entitled to one-half of these accumulations upon dissolution of the marriage by divorce or by death of either partner. While the husband was the manager of the community, he acted, not for himself alone, but for the spouses

⁵ Louisiana has maintained the old civil law in its purest form.

⁶ Today, in Mexico, the spouses, upon marriage, may elect to adopt the community system or to preserve the concept of separate ownership of accumulations during marriage. No such election is available in Texas.

jointly. Theoretically, both partners contributed to the partnership all of their time and efforts together with the use of their separate capital. The separate capital consisted of property owned at marriage and property acquired after marriage by inheritance or by gift. On dissolution of the marriage, the separate capital of each was first restored before a division of profits. If separate property of one of the spouses was on hand when the partnership terminated, that specific property was restored; but, generally, the rule was that on dissolution there was a reimbursement to the separate contributor of the value at the time of the marriage of the separate capital contributed. However, if a specific item of separate property could be traced into the acquisition of another property, the other property became the separate property of the owner of the original separate property. If, for example, Blackacre, which was separate property of the wife, were exchanged for Whiteacre, Whiteacre became the separate property of the wife.⁷

These basic principles were carried into the Texas law, first by the Texas laws of 1840 and then by the Constitution of 1845. The first constitutional provision was continued in later constitutions and now appears as article 16, section 15 of our present constitution. It provides that "All property, both real and personal of the wife, owned or claimed by her before marriage, and that acquired afterward by gift, devise or descent, shall be her separate property; and laws shall be passed more clearly defining the rights of the wife, in relation as well to her separate property as that held in common with her husband."⁸

Statutes of Texas, first enacted in 1848, have contained similar definitions of the separate property of both husband and wife. Article 4613 of the present revised civil statutes defines the husband's separate property as being "All property of the husband, both real and personal, owned or claimed by him before marriage, and that acquired afterwards by gift, devise or descent, as also the increase of all lands thus acquired. . . ." The section also gave the husband during marriage ". . . the sole management, control, and disposition of his separate property. . . ."

Article 4614 gives the same definition of the wife's separate property and gives her like control over her separate property except that it requires the joinder of the husband on the conveyance

⁷ De Funiak, *op. cit.* supra note 1, pars. 63, 69; Huie, *supra* note 1, at VII-VIII.

⁸ It should be noted that while the Texas Constitution, in the main, adopted the common law of England as the basic law, it expressly discarded the common law's somewhat barbaric treatment of the wife and her property following marriage.

or encumbrance of her separate lands and on the transfer of her separate stocks and bonds.⁹

Article 4619 provides that all property acquired by either husband or wife during marriage, except that which is the separate property of either, shall be deemed the common property of the husband and wife; and all the effects which the husband and wife possess at the time the marriage may be dissolved (*e.g.*, by divorce or death of either) shall be regarded as common effects or gains, unless the contrary be satisfactorily proved. This article further provides that during coverture, the common property shall be managed by the husband.¹⁰

Thus, by constitution and by statute, Texas adopted the basic principles of the Spanish civil law's community property system. As to all accumulations during marriage (except property received by gift, devise, or inheritance), the spouses are equal partners.¹¹ Husband and wife each has a vested half interest in these accumulations. While, in most instances, the husband has managerial control over the common property, his control is not absolute or, in any way, the equivalent of ownership. He acts as if he were an agent of the community or as if he were a trustee or as if he were the managing partner of a limited partnership. If he acts in fraud of the wife's rights, she is not without remedy in the courts.¹² Her

⁹ Important changes were made in articles 4614, 4616, 4617 and 4623, *Tex. Rev. Civ. Stat. Ann.* (1951), by the 55th Legislature in the 1957 session laws in relation to the wife's separate property. One of the more important of these changes is that a wife, if 21 years of age, may elect, by filing a statement in deed records of the county of her residence, to have sole management, control and disposition of her separate property, in which case joinder of her husband to the encumbrance or conveyance of her lands and his joinder in transfer of her separate stock and bonds shall not be necessary. These amendments are effective January 1, 1958. *Vernon's Tex. Sess. Laws 1957*, 55th Leg., Reg. Sess., at 1233-35.

¹⁰ Certain exceptions are made. The wife has the management and control of community if the husband dies or becomes insane, *Tex. Rev. Civ. Stat. Ann.* art. 3678 (1952), or if he should disappear and his whereabouts are unknown for twelve months. *Tex. Rev. Civ. Stat. Ann.* art. 4619 (1951). Also, the wife has control over the revenues of her separate property. *Hawkins v. Britton State Bank*, 122 Tex. 69, 52 S.W.2d 243 (1932).

¹¹ In one of the earliest Texas cases, *Cartwright v. Hollis*, 5 Tex. 152, 163 (1849), Chief Justice Hemphill said:

. . . and the obvious purpose of the statute was to preserve from the wreck of the Spanish system of jurisprudence those rules, with some modifications, which regarded the matrimonial union, so far as property was concerned, as a species of partnership. . . .

This has been the dominating theory of subsequent Texas decisions. *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925); *Stone v. Jackson*, 109 Tex. 385, 210 S.W. 953 (1919); *Moody v. Smoot*, 78 Tex. 119, 14 S.W. 285 (1890); *Leatherwood v. Arnold*, 66 Tex. 414, 1 S.W. 173 (1886); *Stramler v. Coe*, 15 Tex. 211 (1855).

¹² *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925); *Martin v. McAllister*, 94 Tex. 567, 63 S.W. 624 (1901); *Stramler v. Coe*, 15 Tex. 211 (1855); *Coss v. Coss*, 207 S.W. 127 (Tex. Civ. App. 1918); *Watson v. Harris*, 61 Tex. Civ. App. 263, 130 S.W. 237 (1910).

rights, aside from managerial control, are equal to his. Thus, on divorce, subject to equitable partition by the court, the community property is divided equally.¹³ At his death, whatever his will may provide, the wife takes half of the community.¹⁴ At her prior death, she may leave her half of the community to whomsoever she pleases, even to a paramour.¹⁵ If she dies without a will, her interest passes to her children, even though their father be another man.¹⁶ Only if she dies intestate and there be no children or lineal descendants does the surviving husband inherit the decedent's share of the community.

3. TAX TREATMENT OF COMMUNITY PROPERTY IN GENERAL

The concept of the marital partnership and of the spouses being equal owners of the marital accumulations is recognized under our tax laws. Thus, upon the death of either spouse, an inheritance tax is levied by the State of Texas only upon the half of the community property which passes at that spouse's death.¹⁷ In 1930 the United States Supreme Court recognized that the interest of a wife in community property in Texas is properly characterized as a present vested interest, equal and equivalent to that of her husband; that one-half of the community income is therefore income of the wife, and consequently she and her husband are entitled to make separate federal income tax returns, each of one-half of such income.¹⁸ Similarly, the Treasury Department, supported by rulings of attorneys general of the United States, held that, in those states in which each spouse owned a present interest in community property, only the half owned by the decedent spouse was includible in his gross

¹³ Tex. Rev. Civ. Stat. Ann. art. 4638 (1951); *Hedtke v. Hedtke*, 112 Tex. 404, 248 S.W. 21 (1923); *Trimble v. Trimble*, 15 Tex. 19 (1855); *Fitts v. Fitts*, 14 Tex. 443 (1855); *Helm v. Helm*, 291 S.W. 648 (Tex. Civ. App. 1927); *Jeter v. Jeter*, 281 S.W. 598 (Tex. Civ. App. 1926); *Hughes v. Hughes*, 259 S.W. 180 (Tex. Civ. App. 1924); *Long v. Long*, 29 Tex. Civ. App. 536, 69 S.W. 428 (1902). We have found no case in which the wife, on divorce, was awarded less than one-half of the community property. The husband's acts have been made the basis for awarding the wife more than one-half of the community. *Scannell v. Scannell*, 117 S.W.2d 538 (Tex. Civ. App. 1938).

¹⁴ Tex. Rev. Civ. Stat. Ann. arts. 2578, 4619 (1951); *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925); *Wright v. Hays*, 10 Tex. 130 (1853).

¹⁵ Tex. Rev. Civ. Stat. Ann. art. 8281 (1956); *Rogers v. Trevathan*, 67 Tex. 406 (1887); *Moss v. Helsley*, 60 Tex. 426 (1883); *Brown v. Pridgen*, 56 Tex. 124 (1882).

¹⁶ Tex. Rev. Civ. Stat. Ann. arts. 2578, 2582 (1951).

¹⁷ *Hensen v. Blackmon*, 169 S.W.2d 955 (Tex. Civ. App. 1942), *aff'd*, 140 Tex. 536, 169 S.W.2d 962 (1943); *Jones v. State*, 5 S.W.2d 973 (Tex. Civ. App. 1928).

¹⁸ *Hopkins v. Bacon*, 282 U.S. 122 (1930). Similar decisions were made respecting four of the other community property states. *Arizona*, *Goodell v. Koch*, 282 U.S. 118 (1930); *California*, *United States v. Malcolm*, 282 U.S. 792 (1931); *Louisiana*, *Bender v. Pfaff*, 282 U.S. 127 (1930); *Washington*, *Poe v. Seaborn*, 282 U.S. 101 (1930).

estate for estate tax purposes.¹⁹ These rulings were consistently followed by the federal taxing authorities and applied by the courts up until 1942.²⁰

In 1942, Congress adopted amendments to the estate and gift tax laws directed specifically against the community property states.²¹ Congress felt that citizens in the community property states were enjoying preferential estate tax treatment since on the death of the husband, only one-half of the community property was subject to estate tax.²² Seeking to remove this tax advantage, the amendment taxed all community property to the first spouse to die except such of it as was economically attributable to the survivor, that is, except such as was traceable to or was "derived originally from" either the personal earnings or the separate property of the survivor. These amendments discriminated against the community property states affected; it produced hardship in many cases and created impossible burdens of tracing all transactions of a married life in the futile effort to determine to what extent every item of community property on hand at death was economically attributable to the survivor. These amendments were first attacked on constitutional grounds but the United States Supreme Court held that they were not unconstitutional,²³ whereupon efforts were made to repeal the amendments.

In 1948, Congress was prevailed upon to repeal (though not retroactively) these unfortunate amendments. However, it did so only because the repeal was accompanied by comprehensive changes in the income, gift and estate tax laws which were designed to equalize all these taxes as between the common law and the community property states. The so-called equalization bill was adopted

¹⁹ T.D. 2450, promulgated February 14, 1917; T.D. 3138, 4 Cum. Bull. 283 (1921); T.D. 3670, IV-1 Cum. Bull. 19 (1925). It was pointed out by the Attorney General in T.D. 3670:

If the widow takes by virtue of her ownership in community property which is held by the community subject only to the power of disposition of the husband, obviously the estate tax has no application. . . . [A] study of the true character of that interest as it existed in the Spanish law, and as it has been developed in the jurisprudence of the community property states . . . affords no substantial basis for the hope that a renewal of the litigation on this subject in the Federal Courts would change the result.

²⁰ *Lang's Estate v. Commissioner*, 304 U.S. 264 (1938); *Commissioner v. Cadwallader*, 127 F.2d 547 (9th Cir. 1942); *United States v. Goodyear*, 99 F.2d 523 (9th Cir. 1938); *Wardell v. Blum*, 276 Fed. 226 (9th Cir. 1921), cert. denied, 258 U.S. 617 (1921); *Burkett Estate*, 3 B.T.A. 1158 (1926); G.C.M. 7773, IX-2 Cum. Bull. 426 (1930).

²¹ Int. Rev. Code of 1939, § 811(e), as amended, Revenue Act of 1942, § 402(b).

²² H.R. Rep. No. 2333, 77th Cong., 2d Sess. 35-37, 160 [1942-2 Cum. Bull. 401]; S. Rep. No. 1631, 77th Cong., 2d Sess. p. 231-32 [1942-2 Cum. Bull. 504].

²³ *Wiener v. Fernandez*, 326 U.S. 340 (1945) (La.).

as a part of the Revenue Act of 1948,²⁴ and these changes have been carried forward into the Revenue Code of 1954.

Equalization was achieved in the income tax by the so-called split return, under which married persons were permitted at their election to combine their respective incomes on a single joint return. The combined taxable income was divided by two, and an income tax then computed on one-half of the combined taxable income. The resulting tax was then multiplied by two, in order to arrive at the total tax of both spouses. In this way, taxpayers in common law states were given the privilege of paying the same tax on the same income as was payable in community property states where spouses filed separate returns.

Equalization was also substantially achieved in the estate tax area by the repeal of the 1942 amendments and by the adoption of the so-called "marital deduction" provisions.²⁵ Under those provisions, if a taxpayer dies in a common law state, his estate is allowed a deduction for estate tax purposes of the value (not to exceed one-half of his adjusted gross estate) of all his property passing to the surviving spouse. However, to obtain the deduction, the surviving spouse must receive the property outright or with a general power of appointment so that the property will be subject to estate tax on his or her subsequent death. By allowing an estate tax deduction for property passing to the surviving spouse (up to one-half of his property), a common law taxpayer could by will leave his wife one-half of his property, with the result that his estate tax would be the same as that of a taxpayer in a community property state, where, by state law, the wife owns half of the community and therefore only one-half of the community is taxed at death.

In the common law states the same community property principle was extended to gift taxes. Only one-half of the value of a gift of separate property to the wife is subject to gift tax, and in the case of gifts to third parties, the common law citizens are now permitted to treat gifts of separately owned property as if they were given equally, that is, as if they were gifts of community property. In the community property states these marital deduction and split gift provisions are not applicable to community property but are

²⁴ Revenue Act of 1948, §§ 301, 302, 303, 351, 361 and 363, amending Int. Rev. Code of 1939, §§ 12, 23(aa), 51(b), 811(d), (§ 811(c)(2) repealed), 812, 813 and 936(b).

²⁵ Int. Rev. Code of 1939, § 812(e) as amended, Int. Rev. Code of 1954, § 2056.

applicable to separate property.²⁶ Thus the community property laws have caused basic changes to be made in the federal estate, gift and income tax laws, and today the marital deduction and marital deduction trust emanating from these changes have become cornerstones in estate planning in common law and community property states alike.

4. PARTICULAR RECEIPTS DURING MARRIAGE—WHETHER COMMUNITY OR SEPARATE

In estate planning; in the filing of estate and gift tax returns; in the filing of income tax returns where separate returns are filed;²⁷ in the administration of an estate or in preparation of a property settlement agreement at divorce, the first consideration is to ascertain those items of property or income which are community and those which are separate.

As stated above, under Texas law, all property acquired during marriage except that acquired by way of gift, devise or descent, is the common property of the spouses. It follows that most receipts during marriage and almost all items of income are community.

Thus, there falls into the community:

(a) The revenues from either spouse's separate estate, whether that estate was owned at marriage or thereafter acquired by gift, devise or descent. This will include rents from separately owned real estate; dividends from separately owned stocks; interest from separately owned bonds.²⁸

²⁶ Int. Rev. Code of 1939, §§ 1000, 1004, as amended, Int. Rev. Code of 1954, §§ 2513, 2523.

²⁷ While a majority of the spouses in Texas file joint returns, making the distinction between community and separate income immaterial, separate returns are common. Where the wife has a large separate estate and where the husband is engaged in a hazardous operation, the parties may be well advised to file separate and not joint returns. If a separate return is filed, the wife (and her separate estate) is liable only for tax (and tax deficiencies) attributable to her half of the community earnings. However, if a joint return is filed, the liability for the tax is joint and several, Int. Rev. Code of 1954, § 6013(d)(3), so that if a substantial deficiency should result and the husband be unable to respond, the wife's separate estate would be liable for the entire tax. Likewise, separate returns are used where there are net capital losses resulting from sales within the year of community property. Since each spouse has a separate capital loss, each will have the benefit of the \$1,000 ordinary deduction (carried over for five years) under § 1211(b) of the code; whereas, if a joint return is filed only a single \$1,000 capital loss deduction is allowed. U.S. Treas. Reg. 1.1211-1(d) (1957). Moreover, if separate returns are filed and a deficiency asserted, one of the spouses could pay his deficiency and sue for refund and the other refuse to pay and go into the Tax Court by way of a 90-day letter, thus making two forums available to litigate the same question. A speedier determination of the issue via the district court on the refund claim can thus be obtained by paying only half of the combined deficiency.

²⁸ As indicated above, the California and Washington rules are different.

(b) All personal earnings of either spouse. This will include salaries, wages, bonuses, pension and profit-sharing receipts, earnings of lawyers, accountants and other self-employed. It would include the \$64,000 earned on a quiz program or a Nobel Prize Award.

(c) Gains derived from farming, ranching, storekeeping, manufacturing, and all similar activities, even though the capital employed be initially the separate property of either spouse.

(d) Gains from partnership operations, whether or not separate funds are invested in the venture.

(e) All fortuitous gains; the discovery by either spouse of a uranium mine; treasure trove; the finding of an unclaimed article belonging to another.

(f) All awards for damages for personal injuries or torts.

(g) Earnings of minor children.

(h) Property acquired by prescription, adverse possession or on credit after marriage.

In short, practically everything acquired by either spouse during marriage, except that received gratuitously, is community property under the constitution and laws of Texas; and these state rules control for all federal tax purposes. However, there are some exceptions and important limitations, having a bearing upon estate planning and upon federal income and federal estate taxation. These exceptions relate to certain proceeds from a spouse's separate property:

A. *Capital Gains*

Of course, the capital gain on the sale of a community asset is community, but what if property owned before marriage substantially appreciates in value after marriage and is sold for a profit? Is the gain separate or community, or is so much of the gain representing postmarital appreciation community? An earlier decision of the Board of Tax Appeals held that the capital gain on the sale of personalty was a community gain under its interpretation of our law and was, therefore, to be divided on separate returns for income purposes.²⁹ The Bureau accepted this decision for a time. However, it was clearly wrong and a later decision of the Fifth Circuit, in the *Skaggs* case, corrected the error, holding that the entire amount of capital gain, including postmarital appreciation, was the separate gain of the spouse whose separate property was sold.³⁰ The *Skaggs* case undoubtedly correctly reflects the Texas law. A sale of separate property is merely a mutation or change in the form of the separate property. As the separate property goes up in value,

²⁹ *Carter v. Commissioner*, 36 B.T.A. 853 (1937).

³⁰ *Skaggs v. Commissioner*, 122 F.2d 721 (5th Cir. 1941).

it is still separate property because acquired before marriage or by way of gift, devise or inheritance. If it is sold and a profit realized from the increase in value, the entire proceeds of the sale are separate because there has been simply a substitution of money for the separate property—a change of form and not of character.³¹ Thus, for federal tax and other purposes, profits from the sale of separate property go to the owner of the property, and not to the community.³²

B. Oil and Gas Receipts

Another exception to the general rule relates to certain income received during marriage from oil, gas or other mineral interests which are separately owned. It is well settled, both under Texas law and the federal tax law, that royalties received under a lease of separate lands are separate and not community.³³ This is because the oil in place represented by the royalty interest is owned by the separate owner of the land and the royalty receipts are but payments for such separately owned oil, and, as in the case of a sale of separate property, merely a substitution in form, and not a change in character of the separate asset. It is important to note that, for purposes of determining the *ownership* of the royalty receipts, the separate owner is treated as if he had sold his separate oil; yet for *federal tax* purposes, these receipts are treated as *ordinary income*, subject to the depletion allowance, and are not given capital gain treatment.³⁴

Similarly, bonuses received during marriage on the execution of a lease of separate land are separate income, and not community.³⁵ This is true, whether the bonus be treated as the consideration re-

³¹ Gleich v. Bongio, 128 Tex. 606, 99 S.W.2d 881 (1937); Rose v. Houston, 11 Tex. 324 (1854); Love v. Robertson, 7 Tex. 6 (1851); Cabell v. Menczer, 35 S.W. 206 (Tex. Civ. App. 1896); Evans v. Purinton, 34 S.W. 350 (1896) error ref.

³² Depreciation allowed by the code should be taken by the separate owner even though the gross income will be separately reported, half by each spouse. This is because the depreciation is allowed as a partial return of the owner's cost, and the wife has no investment in the separate property of the husband.

³³ Texas Co. v. Parks, 247 S.W.2d 179 (Tex. Civ. App. 1952); Lessing v. Russik, 234 S.W.2d 891 (Tex. Civ. App. 1950); Bantuelle v. Bantuelle, 195 S.W.2d 686 (Tex. Civ. App. 1946); Stephens v. Stephens, 292 S.W. 290 (Tex. Civ. App. 1927) error dism. See also State v. Hatcher, 115 Tex. 332, 281 S.W. 192 (1926) (revenues of the state from lease of state lands are a return of principal); Welder v. Commissioner, 148 F.2d 583 (5th Cir. 1945) (royalties are separate for income tax purposes); McFaddin v. Commissioner, 148 F.2d 570 (5th Cir. 1945) (same); Commissioner v. Wilson, 76 F.2d 766 (5th Cir. 1935) (same).

³⁴ Harmel v. Commissioner, 287 U.S. 103 (1933).

³⁵ Welder v. Commissioner, 148 F.2d 583 (5th Cir. 1945); McFaddin v. Commissioner, 148 F.2d 570 (5th Cir. 1945); Crabb v. Commissioner, 119 F.2d 772 (5th Cir. 1941); Commissioner v. Wilson, 76 F.2d 766 (5th Cir. 1935). Bonuses are separate although leases are surrendered without production. Bennett v. Scofield, 170 F.2d 887 (5th Cir. 1948).

ceived on the sale of a determinable fee under Texas property law³⁶ or as an advance royalty under the federal tax law.³⁷

On the other hand, delay rentals are more in the nature of rent and are considered, under both state and federal law, as community, even though paid under a lease of separate lands.³⁸

Income during marriage of an operating lessee from a lease owned before marriage or from a lease acquired by gift, devise or descent presents a more troublesome problem. Here, the law is not too clear. For many years, the Treasury Department has held that income from a separately owned working interest is community income, and not separate.³⁹ Apparently, this is the rule being followed today for income tax purposes. The theory is that income from a working interest, unlike royalty income, involves the application of community efforts and skill and expenditures of monies for operation so that the income is more nearly akin to the profit derived from a manufacturing operation than it is to a simple receipt of money on the sale of separate property. The separate lease is regarded as being contributed to an active business, the income of which is community. Some support for this view is found in several old cases dealing with the application of community effort to separate property.⁴⁰

However, the recent decision of the Texas Supreme Court in *Norris v. Vaughan*⁴¹ takes the other view, at least as to leases fully developed before marriage. In that case, gas wells had been drilled before marriage on a separately owned lease. After marriage, little time or effort was required to maintain or operate the wells, and no community funds were expended in their development or operation. Under these facts the Court chose to follow the rule applicable to separately owned royalties and held the income from the gas wells to be separate. The Court viewed the production as a piecemeal sale of the separately owned gas and relied on the capi-

³⁶ *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923).

³⁷ *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1932).

³⁸ *Bennett v. Scofield*, 170 F.2d 887 (5th Cir. 1948); *Commissioner v. Wilson*, 76 F.2d 766 (5th Cir. 1935); *McGarraugh v. McGarraugh*, 177 S.W.2d 296 (Tex. Civ. App. 1943) error dismissed.

³⁹ G.C.M. 13742, XIII-2 Cum. Bull. 181 (1934).

⁴⁰ *White v. Hugh Lynch & Co.*, 26 Tex. 195 (1862) (finished lumber sawed from separate timber is community); *Craxton v. Ryan*, 3 Willson, Civ. Cas. Ct. App. 367 (1888) (bricks from clay extracted from separate lands are community). As stated by the Supreme Court in *De Blane v. Hugh Lynch & Co.*, 23 Tex. 25, 29 (1859):

If a crop is made by the labor of the wife's slaves on the wife's land, it is community property, because the law presumes that the husband's skill or care contributed to its production; or, that he, in some other way, contributed to the common acquisitions.

⁴¹ *Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676 (1953).

tal gain and royalty cases above referred to.⁴² The Court also relied on the statute (article 4613) which gives the husband management and control over his separate property and held that reasonable control and management is necessary "to preserve the separate estate and put it to productive use;" and that in this case the production and maintenance operations on the gas wells were necessary to their use and preservation and in the nature of reasonable control and management of the separate estate.

This decision changes the tax rule of G.C.M. 13742,⁴³ at least as to fully developed gas leases. But it leaves the law in this area in a state of uncertainty. Does the Court mean that only if a little time is spent on operations is the income to remain separate, or does it mean that whatever time or effort may be required is reasonable if "necessary to preserve the separate estate and put it to productive use;" is each case to depend on its own facts and upon the extent of the effort expended? What is the rule if the separate lease was a wildcat property at the time of the marriage and a discovery well is drilled after marriage? What if it was only partly developed before marriage? What if a substantial amount of community effort or of community funds went into the development? What if the operation involved a recycling or extraction plant? The decision leaves these questions unanswered. Where the line is to be drawn must be worked out in future litigation.

Professor Huie suggested⁴⁴ that the state legislature might adopt a mathematical rule similar to the rule in the Texas Trust Act. The Trust Act provides, in the case of a depleting asset, that in determining what is income and what is principal as between life beneficiary and remainderman, 27½ per cent of the receipt (unless the creator of the trust specifies otherwise) shall be deemed corpus, and 72½ per cent shall be deemed income, distributable to the income beneficiary. He suggests that some similar rule be adopted in these cases and that some arbitrary percentage of postmarital receipts be allocated to the owner of the separate mineral interest to compensate for the exhaustion of his separate interest and the remainder of the income be awarded to the community. Perhaps a better rule, and one not requiring legislation, would be for the Texas Supreme Court to adopt accepted civil law principles in this type of case. The Court could say that where the oil operator comes into the marriage with an oil lease and thereafter carries on an oil business, he has

⁴² See notes 31 and 33, *supra*.

⁴³ XIII-2 Cum. Bull. 181 (1934).

⁴⁴ Huie, *supra* note 1, at XLVI.

contributed his separate lease to the community business; that the lease and all revenues from the operation thereof become community property; and on dissolution of the marriage by death or divorce, his separate estate is entitled to reimbursement for the value at the time of the marriage of the contributed lease. If the contributed lease were unproven, and of small value, the reimbursement would be small; but if proven or developed, the reimbursement would be made accordingly. This rule is based on sound civil law principles; would be more equitable; and would be relatively easy of administration. Whether the Court will reinstate this salutary rule of reimbursement in this type of case remains to be seen.⁴⁵

C. Corporate Distributions

A third exception to the general rule that all non-gratuitous receipts during marriage are community relates to certain corporate distributions. Of course, ordinary dividends are community, whether paid with respect to separate or community stock. However, a stock dividend, representing a capitalization of surplus, is a mere proliferation of the outstanding separate stock interest, and if paid with respect to separate stock would be separate.⁴⁶ By the same token, stock received on a stock-split of separate stock would be separate, as would stock or securities received on a recapitalization or other corporate reorganization.

The treatment of money or "boot" received in connection with a reorganization is yet unsettled in Texas. Treated as additional consideration received on the exchange, it may be held to be separate under the capital gain and exchange case. However, it may be viewed, as under the tax law,⁴⁷ as income, if it has the effect of a dividend paid out of the accumulated earnings of the corporation. Considering that the community is the favored estate, the latter should be the rule unless the amount of cash in relation to the value of the exchanged stock is so large as to make it predominantly a sale.

⁴⁵ See discussion of the reimbursement principle, *infra*. The suggested rule would also be correlative of rules prevailing in most states, relating to trusts. If a man transfers oil properties to a trust, with income payable to the wife and with a reversion to himself in event of her death or their divorce, proper trust accounting would require a valuation of the property as of the establishment of the trust. In determining distributable income, this value (corpus) would be maintained through a cost depletion deduction so that only the net true income would be paid the wife.

⁴⁶ While no Texas case has been found so holding, the Fifth Circuit has so held, *Scofield v. Weiss*, 131 F.2d 631 (1942), and this decision seems entirely sound. Cf. *Eisner v. Macomber*, 252 U.S. 189 (1920). A persuasive analogy is found in § 296 of the Texas Trust Act, art. 7425b-29 (1951), which provides that as between a life beneficiary and the remainderman of a trust, a stock dividend received by the trust shall be deemed corpus or principal and not income.

⁴⁷ Cf. Int. Rev. Code of 1954, § 356.

The treatment of distributions in liquidation of separately owned stock likewise remains to be settled. If the distributions are received in redemption of stock, whether on a complete liquidation of the corporation or on a redemption of a stockholder's interest, in whole or in part, the transaction, it is submitted, should be viewed as essentially a sale; the sale cases should apply; and the amount distributed treated as separate. Query as to the rule if there is a proportionate distribution and redemption which is essentially a dividend for income tax purposes.⁴⁸

Also unsettled is the case of extraordinary dividends; for example, a very large dividend paid on separate stock in connection with a corporate contraction and not in the normal course of business. Here, the Texas Supreme Court could go either way. Since stock is not surrendered and considering the broad statutory definition of community property and that the community is the favored estate, it is believed the Court should hold the distribution to be community.⁴⁹

It should be noted that under Texas law, a corporate stock which is separate property retains its separate character, no matter how much it increases in value as a result of corporate earnings during marriage, and indeed, even if the corporation be charged with unreasonable accumulations of surplus.⁵⁰ Thus, the corporate device may be utilized to prevent income from separate properties going to the community. If a spouse owning separate property desires to avoid the effect of our community laws and to keep future income for himself, he has but to incorporate his separate property and impound the earnings in the corporation until such time as his marriage has become tested and tried.

D. Limited Estates and Annuities

A final exception to the general rule governing marital receipts relates to gifts of *future* income from property. Property received by way of gift, devise or descent is separate. If a father leaves his married daughter \$100,000, that, of course, is separate. If he leaves her \$100,000 to be paid by the executors in ten equal annual installments, these payments are likewise gifts and therefore separate. But, what if he sets up a trust with directions that out of income or corpus the trustees shall pay her \$10,000 annually, for life? What if he leaves her the income from a property for a term of ten years?

⁴⁸ Cf. Int. Rev. Code of 1954, § 302.

⁴⁹ Under the Texas Trust Act, extraordinary dividends are treated as income and not principal. Tex. Trust Act art. 7425b-29A (1951).

⁵⁰ Scofield v. Weiss, 131 F.2d 631 (5th Cir. 1942); Estate of Lucy v. Commissioner, 13 T.C. 1010 (1949).

What if he leaves her a life estate or the income of a trust for life? Are the receipts by her in each of these cases separate or community?

Under the civil law and under the Louisiana law, income from a separate estate for a term of years is separate, whereas, income received from a separate life estate is community.⁵¹ But the Texas law is far from settled. The Fifth Circuit in two cases has held, at least in the absence of a contrary expression of intention by the testator or settlor, that the income received by the life tenant or life beneficiary falls into the community.⁵² However, the Supreme Court of Texas in a holding during the Reconstruction era⁵³ and a later Court of Civil Appeals case⁵⁴ have held that if the testator or settlor clearly manifests an intention that the rents and revenues from the life estate or equitable life estate are to be the beneficiary's sole and separate property, this intention will control. These latter two decisions are of doubtful validity today. The constitution and statutes define the separate and community property of the spouse. Later Texas Supreme Court cases make it clear that the law, rather than the intention, controls. Even the legislature may not enlarge upon the constitutional definition of the wife's separate property.⁵⁵ And the spouses by their inter vivos agreements may not change the character of property as established by the constitution and statutes of Texas.⁵⁶ It should follow that the expression of an intention on the part of a testator or settlor cannot do so. It is felt that the two cases giving effect to the testator or settlor's intention are not the law today, but that the two Fifth Circuit decisions, holding that income from a life estate is community, are consistent with the principles of our community property system.⁵⁷ Whether our courts will adopt the Louisiana rule, and hold that income from a separate estate of a term for years will be separate, remains to be seen.

A possible solution to the life estate versus term of years problem would be for our Supreme Court to go back to civil law principles and re-adopt the reimbursement rule. The Court could say as to both estates that they represent separate capital which is contributed

⁵¹ Huie, *supra* note 1, at XXXVII; La. Civ. Code Ann. art. 2371 (West 1952).

⁵² *Commissioner v. Porter*, 148 F.2d 566 (5th Cir. 1945); *Commissioner v. Terry*, 69 F.2d 969 (5th Cir. 1934).

⁵³ *Hutchinson v. Mitchell*, 39 Tex. 487 (1873).

⁵⁴ *Sullivan v. Skinner*, 66 S.W. 680 (1902). See also concurring opinion of Judge Waller in *Commissioner v. Estate of Hinds*, 180 F.2d 930 (5th Cir. 1950).

⁵⁵ *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925).

⁵⁶ *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902); *Gorman v. Gause*, 56 S.W.2d 855 (Tex. Civ. App. 1933).

⁵⁷ See Huie, *supra* note 1, at XXXVI.

to the community, and hence all income received, whether for life or for a term of years would be community, but on dissolution of the marriage the contributor would be entitled to a reimbursement of the commuted value of the estate at the time of its contribution to the community.⁵⁸

The annuity type of case presents a different and more interesting possibility. Assume that a spouse is bequeathed an annual sum payable out of income or, if need be, out of corpus. Here, the facts may vary. The annuity payments may, in fact, be paid all out of income, or principally out of corpus or out of both, with no way of saying which. Is the receipt altogether a gift or devise and, therefore, separate? Or, is it all community? Or, is some rule of apportionment to be attempted?

In the *McClelland* case⁵⁹ the husband was given an annuity for life to be paid out of the principal or income of a trust estate. The court held that each annuity payment was a gift and that the amounts received were all separate. Considerable support for this view may be found in earlier tax decisions to the effect that annuities payable out of income or corpus are gifts or devises, and not income subject to federal income tax.⁶⁰ Much use was made of these decisions in the drafting of trusts involving income tax planning. While the income tax rule was later changed,⁶¹ these income tax cases support the view of the *McClelland* case that an annuity payable out of corpus or income is itself a gift and not income from a separate estate. Since there is a very good possibility that the *McClelland* case will be followed today, consideration should be given to that rule in estate planning. A father, desiring to protect a married daughter, might be well advised to leave her a fixed annuity payable out of income and principal.

5. SOME TRACING PROBLEMS

When a marriage is dissolved by death or divorce, it becomes important for tax and other reasons to segregate the separate property from the community. This frequently involves tracing problems. Tracing, from an estate planning or an estate tax point of view, may be important in various types of cases: (1) Separate property may be sold. Under the capital gain cases referred to

⁵⁸ See discussion of the reimbursement principle, *infra*.

⁵⁹ *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896) error ref.

⁶⁰ *Pardee v. Helvering*, 290 U.S. 365 (1933); *Burnet v. Whitehouse*, 283 U.S. 148 (1931).

⁶¹ Revenue Act of 1942, §§ 110(a), 111(c), amending Int. Rev. Code of 1939, §§ 22(b)(2), 162.

above, the proceeds are separate. If these separate funds can be traced into a new acquisition, such new acquisition takes on the separate character of the purchase price. (2) Royalty or other separate receipts may be invested in the acquisition of a new property. (3) Separate funds, together with community funds, may enter into a specific acquisition, in which case the new property will be owned by both the community and separate estates in proportion to funds subscribed by each estate. Thus, in the early case of *Love v. Robertson*⁶² the husband purchased a slave for \$800. He paid \$330 out of his separate funds and the balance was paid out of community funds. It was held that the slave was owned, 330/800 by the separate estate, and 470/800 by the community. (4) Community funds may be used to improve separate property, for example, a house may be built after marriage with community funds upon the separate lands of one of the spouses. The land remains separate and the house becomes separate (being affixed to the freehold) but the community estate is entitled to be reimbursed for the amount of the community funds expended for the benefit of the separate estate. (5) Similarly, if separate funds are used to pay off a debt upon community property or are otherwise expended on behalf of the community, the separate estate will be entitled to reimbursement from the community.⁶³

Tracing of separate funds into the acquisition of a particular property may often prove difficult and, more often than not, is impossible. Under the statute (article 4619), all effects which the husband and wife possess at the time the marriage is dissolved are regarded as community "unless the contrary be satisfactorily proved." Thus, all doubts are resolved in favor of the community, and many substantial separate estates have disappeared into the community because of the inability to trace the separate funds into a particular asset on hand at the dissolution of the marriage.⁶⁴ Where the tracing may involve a chain of sales and purchases over a long married life, the evidence available at death or divorce necessary to rebut the community presumption may be lacking unless careful records are kept. But the mere keeping of records is not enough. The person desiring to impress a separate ownership on a particular asset has the burden of showing that specific separate funds went into a particular acquisition. This involves the tracing of actual

⁶² 7 Tex. 6 (1851).

⁶³ *Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676, 682 (1953); *Dakan v. Dakan*, 125 Tex. 305, 83 S.W.2d 620 (1935); *Allen v. Allen*, 101 Tex. 362, 197 S.W. 528 (1908); *Snodgrass v. Robertson*, 167 S.W.2d 534 (Tex. Civ. App. 1942).

⁶⁴ See, e.g., *Rippy v. Rippy*, 49 S.W.2d 494 (1932) error ref.

dollars. Where a spouse desires to preserve separate ownership of specific acquisitions during marriage, he should maintain two separate bank accounts in his name. One, his investment account, and another, his income account. If an item of separate property is sold, the proceeds should be deposited in his investment account. His dividends, interest and other community items should be deposited in the separate income account, and not mingled with the investment funds. Royalty receipts, if separate, would go into the investment account. Current expenses would be paid out of the income account; and all new investments and reinvestments cleared only through the investment account which, from the bank records and the spouse's records, can be shown to be, at all times, exclusively separate. Only in such a way, avoiding commingling, can he be sure of being able to provide the necessary proof.

Mention should be made of article 4622 of the Texas statutes. That article provides that "funds on deposit in any bank or banking institution, whether in the name of the husband or wife, shall be presumed to be the separate property of the party in whose name they stand, regardless of who made the deposit. . . ." This article was enacted primarily for the guidance of banks in receiving and disbursing deposits; it is a rebuttable, not a conclusive presumption; it was not intended to supplant or destroy the provisions of article 4619, that all property acquired by either husband or wife during marriage shall be deemed community.⁶⁵ Unless the presumption of article 4622 is overcome by the tracing of the funds deposited, the deposit will be held to be the separate property of the spouse in whose name it stands.⁶⁶ However, a showing that the deposit was made with community funds would rebut the presumption and make the deposit community. Thus, household money deposited in the wife's name out of the husband's earnings, or dividends received by the wife on her separate stocks, deposited in her name, if identified as a community item, would make the deposit community.⁶⁷ However, even if it is established, by tracing, that the deposit was of community funds and thus community, the separate claimant may still establish that it is nevertheless separate because a gift by the other spouse of his interest was intended. This might

⁶⁵ *Taylor v. Suloch Oil Co.*, 141 S.W.2d 657 (1940), error dism. judgm. cor.

⁶⁶ *Graham Nat'l Bank v. First Nat'l Bank*, 48 S.W.2d 358 (Tex. Civ. App. 1932); *Emerson-Brantingham Implement Co. v. Brothers*, 194 S.W. 608 (Tex. Civ. App. 1917). community property in Louisiana, 30 Texas L. Rev. 157 (1952).

⁶⁷ *Sorenson v. City Nat'l Bank*, 293 S.W. 638 (Tex. Civ. App. 1927); *Ralls v. Ralls*, 256 S.W. 688 (Tex. Civ. App. 1923); *Armingen v. Martin*, 252 S.W. 1109 (Tex. Civ. App. 1923); *Hightower v. Hightower*, 236 S.W. 197 (Tex. Civ. App. 1921).

be shown by parol or other evidence, but the evidence of an intent to make a gift should be clear in order to rebut the presumption of article 4619 that this is community.

It may be added that the mere fact that stock, bonds or other property stands in the wife's name, of itself, gives rise to no presumption that it is her separate property. If it appears that the property was acquired during marriage, the opposite presumption under article 4619 that it is community property prevails, necessitating either a tracing of her separate funds into the acquisition or a showing of a gift to her by her husband or by some one else.

6. REIMBURSEMENT

Related to but different from the problem of tracing is the civil law principle of reimbursement. As stated at the outset, it was a settled principle of the civil law that upon the dissolution of the marriage, there was returned to each spouse, first to the wife and then to the husband, the value of his or her separate capital that was contributed to the marital partnership, following which the balance on hand was equally divided.⁶⁸ This principle has been too often overlooked by lawyers, judges and the Treasury Department. Too much attention has been devoted to attempting to trace separate funds into specific property acquisitions and too little has been devoted to this important and equitable principle of reimbursement.

It is believed that when the marriage is dissolved, whether by death or divorce, instead of putting a separate contributor or his estate to the frequently impossible burden of tracing funds back through the mutations and changes over a long married life, a simple showing that the husband or wife came into the marriage with separate property of a specific value should give such spouse a reimbursement of that amount out of the commingled estate.

In *Moor v. Moor*,⁶⁹ the Court of Civil Appeals refused to allow the application of this principle. And several subsequent Civil Appeals cases have intimated, more by way of dictum than otherwise, that reimbursement will not be allowed.⁷⁰ Accordingly, lawyers are assuming that reimbursement will not be allowed where identifi-

⁶⁸ See Huie, *Separate Ownership of Specific Property versus Restitution from Community Property in Louisiana*, 30 Texas L. Rev. 157 (1952).

⁶⁹ Original opinion 57 S.W. 992 (Tex. Civ. App. 1900), corrected, 255 S.W. 231 (1900) error ref.

⁷⁰ *Edelstein v. Brown*, 55 S.W. 1126 (Tex. Civ. App. 1906), aff'd on another question, 100 Tex. 403, 100 S.W. 129 (1907); *Robb v. Robb*, 41 S.W. 92 (Tex. Civ. App. 1897); cf. *Wagon v. Wagon*, 16 S.W.2d 366 (Tex. Civ. App. 1929).

cation of separate funds is lost through commingling with community funds. In several cases attempts have been made to carry the difficult, if not impossible, burden of tracing separate funds into specific property acquisitions, and no attempt was made to ask for reimbursement, although that easier remedy was available.⁷¹

It should be observed, however, that no Supreme Court case has held that this civil law principle is not the law of Texas today, and in the important earlier decision of the Supreme Court in *Schmidt v. Huppmann*,⁷² the right of reimbursement was specifically recognized. There, the Court said:

Where it satisfactorily appears, as in this case, that one spouse brought into the partnership funds invested in a particular business, which business was carried on and the profits arising therefrom used in creating and building up the community estate, and the separate funds are employed in the same business, at the dissolution of the partnership, upon settlement with the community estate, we think the spouse furnishing such separate funds is entitled to be reimbursed therefor.

Despite some uncertainty created by the Civil Appeals cases referred to, it is submitted that the civil law principle of reimbursement is, and should be, the law of Texas today. It is an equitable and fair rule and relatively easy of practical administration.

The rule of reimbursement is recognized in many cases where community funds are used for the benefit of a specific separate property or where separate funds are used to the improvement of or the benefit of a particular community asset.⁷³ These cases, in principle, support the proposition that if an ascertainable amount of separate funds are contributed either to a particular community acquisition or to the general community acquisitions, reimbursement should be allowed.

If separate funds are committed to a community operation and their identity lost, it cannot be said that the contributing spouse is making a gift to the community unless he so intended. Usually no donative intent is involved. Even if the spouse intended to give his separate funds to the community, the attempt would be futile, since under the Texas constitution and statutes, property acquired by gift is separate and not community and the Texas Supreme Court has held that under our law, direct gifts to the community are not

⁷¹ *Gibson v. Gibson*, 202 S.W.2d 288 (Tex. Civ. App. 1947); *Rippy v. Rippy*, 49 S.W.2d 494 (Tex. Civ. App. 1932).

⁷² 73 Tex. 112, 11 S.W. 175 (1889).

⁷³ See note 63, *supra*.

possible.⁷⁴ If, then, the contribution is not, and cannot be, a gift, then it is truly an advance or loan, and reimbursement or repayment should be allowed.⁷⁵

Of course, both remedies cannot be allowed at the same time. The spouse or the executor claiming separate ownership must elect his remedies. He must decide whether to trace separate funds into specific, identifiable property on hand at the dissolution of the marriage, or he must put in his claim for reimbursement of the funds advanced or contributed to the marital partnership.

This principle of reimbursement may have an important bearing on the estate tax liability on the death of a spouse, on the administration of an estate, or in the event of a divorce. It may also be used in connection with marriage settlements. If one of the parties to the contemplated marriage has a substantial separate estate which is sought to be protected, recourse may be had to this remedy of reimbursement. In such cases it is suggested that an inventory be prepared of all separate funds on hand at the time of the marriage, together with the value of any such separate property. With this inventory the spouses should agree (preferably by antenuptial agreement, although a postnuptial agreement should serve), that specified properties are the separate property of the particular spouse and that if any separate funds on hand at marriage or the proceeds from the sale of any separate property are committed to any community business or enterprise, the contributor, upon dissolution of the marriage by death or divorce, shall be entitled to reimbursement of the separate sums so advanced. While the courts have frequently stricken down postnuptial contracts which attempt to change their property rights or to convert community property into separate,⁷⁶ it is submitted that the reimbursement agreement should be recognized. It does not alter the true legal rights in property, but, on the contrary, preserves existing property rights. It simply negates any intention that the contribution is an illegal gift and evidences the intention that the separate contribution shall remain separate, and, as an advance, is to be returned on dissolution of the marriage.

⁷⁴ *Tittle v. Tittle*, 148 Tex. 102, 220 S.W.2d 637 (1949); *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902).

⁷⁵ See Huie's treatment of this subject, *supra* note 1, at § 8, and *supra* note 68.

⁷⁶ Tex. Rev. Civ. Stat. Ann. art. 4610 (1951); *Proetzell v. Schroeder*, 83 Tex. 684, 19 S.W. 292 (1892); *Green v. Ferguson*, 62 Tex. 525 (1884); *Cox v. Miller*, 54 Tex. 16 (1880); *Cannon v. Boutwell*, 53 Tex. 626 (1880).

7. FOOTNOTES ON ESTATE PLANNING

Perhaps more has been written on estate planning than on any other tax subject.⁷⁷ It is unnecessary here to add to the present volumes of literature on the subject except to note instances where some modifications in orthodox estate planning techniques may be required because of our community laws.

A. Trusts

Except for the civil law concept of community property, Texas has adopted the common law of England as a part of its basic law. Consequently, the Texas law recognizes trusts of all types. The Texas Trust Act represents a codification of trust laws prevailing in most of the common law states.⁷⁸ In this respect the Texas law is utterly unlike the law of Louisiana where trusts are relatively new and given only limited recognition. The result is that normal tax planning procedures are in use in Texas, including the use of inter vivos, testamentary, spendthrift and marital deduction trusts.

B. Wills

Since the wife in Texas has full power of testamentary disposition of her half of the community property, she should have a will. The need for a will in her case is more imperative than in the case of a wife in a common law state where she may have only an inchoate right of dower in the marital accumulations. Should the Texas wife die intestate, her children inherit her share of the community property and if the children be minors complications arise. Administration of an intestate estate requires the posting of a bond and the administration under court supervision with attendant expense and delay. Guardianship for the minor children likewise necessitates annual bond, annual accounting and court supervision. Moreover, the investment powers of a guardian in Texas are extremely limited. These consequences are avoided by a will naming an independent executor and trustee for minor children who are directed to serve without bond or court administration.

⁷⁷ The articles are legion. Some of the more recent treatises are Warren & Surrey, *Federal Estate and Gift Taxation* (1952); Lowndes & Kramer, *Federal Estate and Gift Taxes*, Part III (1956); Shattuck and Farr, *An Estate Planner's Handbook* (2d ed. 1953); Casner, *Estate Planning* (1956).

⁷⁸ The draftsman of a Texas trust must observe certain peculiarities in the Texas Trust Act. For example, an inter vivos trust will be revocable unless by its terms it is made irrevocable (art. 7425b-41). The failure to insert a clause of irrevocability will, therefore, produce adverse income and estate tax consequences. Also bond will be required of an individual trustee of an inter vivos or testamentary trust unless expressly waived in the instrument (art. 7425b-251). Again, where oil properties are held in trust 27½% of the oil receipts are considered corpus and 72½% income unless the instrument provides for a different rule (art. 7425b-33).

Separate wills for husband and wife are generally preferred to a joint will.⁷⁹ These will usually contain parallel provisions, each disposing of only half of the community and each taking into account the fact that the survivor is already the owner of half of the community. If the wife's half of the property is adequate for her support and maintenance, the husband leaves his half to the children. If the wife's half may prove inadequate for her support, the testator will leave his half in trust, with all or some part of the income payable to the wife; or the trustee (other than the wife) may have discretionary power to supplement the wife's income in order to maintain her in the station of life to which she is accustomed. Here the usual technique of avoiding the bunching of income and the duplication of estate taxes is employed through the use of the trust in which the wife has a limited life interest with remainder over to the children.⁸⁰ Multiple trusts, *e.g.*, separate trusts for each child, are common in order to achieve the maximum income tax saving. Special powers of appointment are frequently given to the wife or to each child if it is desired to hedgehop another estate tax. The usual spendthrift clauses and corpus invasion provisions in case of need are commonly employed. The wife's will contains a similar testamentary trust or trusts for the children, with the husband either having no interest or at most an interest in only the income or some fraction thereof, depending on the size of the estate and his income from other sources.

In event the wife dies first, the husband is generally named the sole independent executor and trustee in her will so that he alone, following her death, may continue to control and manage the wife's community interest in properties and businesses standing in his name. If the husband dies first, his will names either the wife alone

⁷⁹ From its very nature, a Texas joint will cannot take effect as a joint will while one of the parties survives. *Wyche v. Clapp*, 43 Tex. 543, 548, 549 (1875); *Gorman v. Gause*, 56 S.W.2d 855 (Tex. Comm. App. 1933). A joint will, on the death of one testator, may be probated as his will, and again probated on the death of the other testator as the will of the latter. *Nye v. Bradford*, 144 Tex. 618, 193 S.W.2d 165 (1946). Until the survivor dies and the joint will is again probated the first probate does not operate to pass the property of the survivor and the survivor may be free to remake the will unless he is estopped by accepting benefits under the joint will as first probated. *Heller v. Heller*, 233 S.W. 870 (Tex. Civ. App. 1921); *Sherman v. Goodson's Heirs*, 219 S.W. 839 (Tex. Civ. App. 1920); *Larrabee v. Porter*, 166 S.W. 395 (Tex. Civ. App. 1914). Joint wills in Texas have created some uncertainties and conflicts in the income, estate and gift tax field. See *McFarland v. Campbell*, 213 F.2d 855 (5th Cir. 1954); *Masterson v. Commissioner*, 141 F.2d 391 (5th Cir. 1944); *Commissioner v. Masterson*, 127 F.2d 252 (1942), 128 F.2d 526 (5th Cir. 1942); *Scofield v. Bethea*, 73 F. Supp. 31 (W.D. Tex. 1947), *rev'd*, 170 F.2d 934 (5th Cir. 1948), *cert. denied*, 336 U.S. 944 (1948). Because of these uncertainties as to tax consequences, separate wills are preferred.

⁸⁰ The trust device rather than a life estate with power of sale is preferable principally because of the greater flexibility.

or a bank (or someone else) to act either alone or with the wife, depending on the wife's business experience and acumen. Successor executors and trustees are usually the same in both wills, to the end that on the death of both spouses, whether in a common disaster or otherwise, the same persons may act for the children in the administration of both halves of the community estate.

Where separate property is involved, the marital deduction and the marital deduction trust are used. Here it is to be remembered that under the Code, the marital deduction is not applicable to community property but is applicable to the separate property of the decedent. Aside from the tax advantage of postponing the estate tax on half of the separate property until the surviving spouse dies, the marital deduction serves another very useful purpose in Texas. As pointed out above, after a long married life during which separate funds have been commingled with community funds, tracing of the separate estate may become extremely difficult and sometimes impossible. In order to avoid the expense and uncertainties involved in an attempt at tracing, in order to avoid family disputes and to avoid controversies with the estate tax authorities, the testator may be well advised to devise one-half of any separate property that he may own at death to the surviving spouse to the end that the surviving spouse take at his death not only one-half of the community but also one-half of any separate property of the testator. This means that the survivor will take one-half of all property in which the decedent may have an interest, whether the property be community or separate, thus making tracing with its attendant difficulties unnecessary.

Where the marital deduction is to be sought, it is recommended that the tax formula clause, recommended by so many writers on estate planning, be used only as a last resort.⁸¹ Preferable is a clause which provides, in effect, as follows: "In addition to my wife's interest in our community property, I give, devise and bequeath to her one-half of any separate property that I may own at the time of my death. The properties passing to her under this clause shall be subject to the payment of one-half of the debts outstanding at my death, whether such debts be community or my separate debt, and shall likewise be subject to the payment of one-half of all expenses of administration, but shall be free and clear of all federal

⁸¹ See Warren & Surrey, *op. cit.* supra note 77 at 634.

estate and state inheritance taxes, it being my intention that all such taxes shall be borne by my residuary estate."⁸²

C. *The Election*

Under the Texas law the wife has a vested interest in half the community. The husband at his death may not dispose of the wife's interest except with her consent and approval. If he undertakes to put her to an election and dispose of her community property, she has a reasonable time after his death in which to elect to take under or against the will. The typical election case is one where the husband in his will attempts to leave the entire estate, including his wife's interest therein, to a trustee under a testamentary trust giving the wife all of the net income for her life with remainder at her death to the children. If the wife should elect to take under such a will, two tax questions arise. First, if the commuted value of her life interest is less than the value of her half of the community, then she will be deemed to have made a gift to the children of the difference, which amount will be subject to gift taxes in her hands. If she takes under the will, her entire property passes to the trustee, and she usually will not have funds at hand to pay such taxes. In such case either the will should make provision for the payment of such gift taxes, or her election to take under the will should be accompanied by an agreement with the executor and trustee that the estate (which is secondarily liable under the gift tax statute) will bear the gift tax. In addition, where the wife elects to take under such a will, she is regarded by the Internal Revenue Service as having made a transfer under section 2036 of the Code. By her voluntary act of agreeing that her half of the community may pass under her husband's will, she has adopted that will and since she has a life income thereunder it is held that she has made an *inter vivos* transfer of her property in trust under the terms of which she has retained the use, enjoyment or income from her property for her life. The result is that her estate will be subject to estate taxes on one-half the value of the trust at her later death.⁸³ Because of the gift and subsequent estate tax liabilities, the election will be

⁸² The provision that the marital bequest be free of death duties is, of course, to obtain the maximum marital deduction. Also, the marital deduction may take the form of a marital deduction trust under which the wife's interest in the community, together with half of the testator's separate estate, passes to a trustee to manage and invest with all of the income payable to the wife for life, together with a general power of appointment in her which may be exercised by deed or by will or by will alone. In such case she would be requested to take these benefits in lieu of her community interest.

⁸³ While there is apparently no case so holding, this is the present position of the Revenue Service. This position seems sound, otherwise substantial property values would pass to the second generation free of all transfer taxes.

sparingly used except in connection with a marital deduction trust where separate properties are added.

D. *Inter Vivos Transfers*

Inter vivos gifts to save income and estate taxes are also common in Texas as an integral part of estate planning. Here again, the outright gift, the inter vivos trust and the multiple trusts are used. Usually, other things being equal, the gifts will be made first out of separate property if either spouse owns separate property. This is because, by employing the split gift provisions, the gifts can be treated as gifts of jointly owned property and the gift tax exemptions and exclusions of both spouses utilized. At the same time, by giving away separate property, the larger estate is reduced and the remaining estates of the two spouses more nearly equalized, with the maximum eventual estate tax savings.

In the case of gifts of community property it is recommended that the wife join with her husband in making the gift. While under Texas law the husband, as manager of the community, may make limited gifts of community property, the gift may be set aside if it is in fraud of the wife's rights. Her joinder in a gift removes this question, so while her consent may not be essential, it is preferable for tax and other reasons.

Transfers of community property in contemplation of death, or under which income is retained or the power to alter, amend, revoke, or terminate is retained, are subject to the usual estate tax rules except that usually only the decedent's half of the transferred property is affected.

The *Hinds* case presents an interesting estate planning possibility. There, the decedent in his lifetime transferred certain community property in trust with income to his wife for her life and remainder over. At his death, prior to the death of the wife, the Commissioner sought to include one-half of the value of the trust in his estate under section 811 (c) of the 1939 Code (section 2038, Internal Revenue Code of 1954) on the ground that since under Texas law the income payable to the wife was community, he owned half of it and consequently he had, in effect, made a transfer in trust under which he retained half the income for a period that did not in fact end before his death. The Tax Court held that he had indeed retained half of the income but only half from his half of the property. Consequently, the Tax Court held that one-fourth of the trust was to be included in his estate under section 811(c). However, the Fifth Circuit Court of Appeals reversed, holding that none of the

property was includible since he had "retained" none of the income from the trust under that section. Whether the income payable to the wife was separate or community was immaterial. If the income to her were community, his half interest arose by operation of law and not by virtue of any *retention* by him of such income.⁸⁴

So long as the *Hinds* case remains the law in this circuit, a husband may transfer separate property in trust with income payable to his wife for life with remainder to his children. Through the operation of the community law, he may have half the income during his wife's lifetime and accomplish the transfer of the property to his children at the lower gift tax rates and without estate tax at either his or his wife's death. Similarly, a transfer of community property as in the *Hinds* case can result in the retention of income in him for his life (if the wife outlives him as would usually be the case) and his half passes to the children at the gift tax rather than the estate tax cost. Of course, in such a case, the wife's half will be exposed to estate tax at her death since she will, acting through her husband, have made a transfer of her half, retaining life income.

8. PARTITION OF COMMUNITY PROPERTY

Community property could not be partitioned until the Texas constitutional amendment prompted by the federal estate tax law of 1942.⁸⁵ In 1948, the constitution was amended to permit spouses to divide all or a part of the community, provided such division was in writing.⁸⁶ Pursuant to the amendment, the legislature, in 1949, added article 4624 (a) to the revised civil statutes. This new statute permits a division, if in writing, without prejudice to pre-existing creditors. The division agreement shall not be effective as to subsequent good faith purchasers, or creditors, unless filed in the county records of the county in which the property is situated.⁸⁷ The statute

⁸⁴ *Commissioner v. Hinds*, 180 F.2d 930 (5th Cir. 1950). Judge Waller concurred specially but holding that the income was the wife's separate income and not community because the trust instrument had provided that the income was to be her separate property. The correctness of Judge Waller's decision is open to question. See note 54, supra, and text following. Later the Tax Court in *Wier v. Commissioner*, 17 T.C. 409 (1951), held that an outright gift to the wife of the homestead did not result in a gift with retention of use and enjoyment under § 811(c), and in that case the Commissioner agreed that an outright gift of stocks would not bring half the stocks into the decedent's estate even though dividends received by the wife were community. The *Wier* case was acquiesced in by the Commissioner. It may be questioned whether the acquiescence in the outright gift type of case would mean acquiescence in a *Hinds* case where the wife received income only.

⁸⁵ *King v. Bruce*, 145 Tex. 647, 201 S.W.2d 803 (1947); *Bruce v. Permian Royalty Co.*, 186 S.W.2d 686 (1945) error ref. w.o.m.

⁸⁶ Tex. Const. art. 16, § 15.

⁸⁷ Tex. Rev. Civ. Stat. Ann. art. 4624(a) (1951).

further provides that if the exchange is other than as equal undivided interests in the same property or as equal shares or units of identical personal property, the instrument of exchange shall not be valid unless approved by the district court of the district in which the spouses reside.

A partition of community property would not give rise to any gift tax consequences, since, under the statute, an equal division must be made. Nor would such a partition subject either spouse to an income tax even though the partition may involve exchanges of property of unlike kind.⁸⁸

Under both the 1948 law and the 1954 Internal Revenue Code, the marital deduction rights do not extend to community property, nor to community property that has been converted by partition or otherwise into separate property.⁸⁹ Consequently, while a partition may not give rise to tax liability at the same time it cannot serve to reduce estate or gift taxes.

While no perceivable tax advantages can be obtained by a partition, the partition may occasionally be useful as an adjunct to estate or business planning; for example, where there is a separation but no divorce or where the spouses contemplate changing their domicile to another state. It may also be useful if the husband is about to launch on a hazardous or speculative enterprise and desires to set aside a part of the community, free of gift tax, to his wife as her separate property against the claims of future creditors. Of course, a partition would not put the property beyond the reach of existing creditors.⁹⁰

9. DIVORCE AND TAXES

Divorce brings about a dissolution of the community with a division of the common property. This division is usually evidenced by a property settlement agreement which is generally approved by the court as a part of the divorce decree. It must be remembered that this division is simply an accounting to the wife of that which is already hers and is in no sense alimony.

Where one of the spouses entered the marriage with separate funds and there has been a commingling, the tracing and reimbursement rules discussed above become important in the accounting. In addition, several tax considerations are involved, depending

⁸⁸ See discussion of property settlements on divorce, *infra*.

⁸⁹ Int. Rev. Code 1954, §§ 2056(c)(1)(B), 2056(c)(1)(C).

⁹⁰ Tex. Rev. Civ. Stat. Ann. art. 4624(a) (1951). See *Hornsby v. Hornsby*, 127 Tex. 474 (1936).

on the form and terms of the settlement agreement. The agreement may take the form of an equal division of each item of property as, for example, an equal division of cash on hand; an assignment to the wife of one-half of each acre of royalty; an assignment to her of half of the shares of all stocks on hand, etc. More often the agreement will represent an exchange of properties of like and unlike kind. And frequently it will take the form of a cash or note payment for the wife's half interest in all the properties or in some of them. Then, too, one or the other of the parties may get the better of the bargaining and, in terms of current values, receive more than an even half of the community. What are the tax consequences?

Although for a while, following the decision by the United States Supreme Court in the *Wemyss* case,⁹¹ the Revenue Service sought to impose a gift tax in some cases, the 1954 Code now makes it clear that no gift tax will be imposed in these settlements even though one of the spouses received more than an equal share (Internal Revenue Code of 1954, section 2516). However, the income tax rules were left to be worked out by the courts. The decisions leave a number of questions unanswered but the following rules would seem to apply.

If under the agreement there is an across-the-board separation there would, of course, be no income tax problem since each spouse would take in divided form that which he theretofore owned in undivided form. There would be no sale or exchange and basis would carry over.

Likewise, if the agreement takes the form of an exchange, no gain or loss would be recognized and this would be true whether the exchange is of like or unlike kind. While there are instances in which a divorce settlement may result in gain,⁹² the general rule is that the division of the community is not such an exchange of property as to give rise to gain or loss, even though it takes the form of an exchange of properties of unlike kind and even though the exchange otherwise would not fall under the tax-free exchange provisions of the Code.⁹³ The division is not a commercial transaction to which the exchange provisions are directed. Whether the partition be assimilated to the liquidation of a commercial partner-

⁹¹ *Commissioner v. Wemyss*, 324 U.S. 303 (1944).

⁹² *Long v. Commissioner*, 173 F.2d 471 (5th Cir. 1949); *Johnson v. United States*, 135 F.2d 125 (9th Cir. 1943).

⁹³ *Osceola Heard Davenport*, 12 T.C.M. 856 (1953); *Ann Y. Oliver*, 8 T.C.M. 403, 430 (1949); *C. C. Rouse*, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947); *Frances R. Walz*, 32 B.T.A. 718 (1935).

ship or to the in-kind division of a decedent's estate or to a division of assets among the beneficiaries of a terminated trust, the exchange of properties whether of like or unlike kind should not be taxable.⁸⁴ Thus, except for the bases questions considered below, an in-kind division of properties creates no tax problem for either spouse.

However, we enter into an area of uncertainty where the agreement calls for a cash payment to the wife in excess of her interest in the cash on hand. Here the transaction begins to take on the aspects of a sale rather than a property exchange. It has been held that if "outside" cash is paid to the wife, *i.e.*, the husband settles with the wife with borrowed funds or notes, he has made a purchase, with the result that the wife may have a taxable gain.⁸⁵ This seems to be the rule now in effect—that property settlement agreements are nontaxable unless "outside" cash or notes are involved. It is open to question whether this is a correct rule. A wife may have a taxable gain if the husband purchases the wife's property even though he makes payment only out of his share of the cash on hand. The essential question is whether there has been an exchange of properties only or whether there has been a sale of some or all of her properties. The transaction may involve one or the other or both, depending upon the circumstances. If the wife receives nothing but cash, whatever its source, she should be deemed to have made a sale of all her interest. If the husband gives her notes for her interest, she will have made a sale. If she receives cash or notes for a particular identifiable property, the remainder of the estate being divided in kind, she will have made a sale of that property only and the exchange part of the agreement would be nontaxable. More difficult is the problem where the wife receives excess cash and a division of property, and the excess cash is not attributable to any specific property or properties relinquished by her. Here if the settlement agreement is predominantly an exchange of properties and the excess cash, whether on hand or borrowed, is simply to equalize values, and is not assignable to a particular property which she is relinquishing, the transaction should be nontaxable, the amount of the excess cash going to reduce her basis in the properties received.

These possibilities of taxable gain to the wife should be considered in drafting property settlement agreements. If excess cash

⁸⁴ Cf. *M. L. Long*, 35 B.T.A. 95, 98 (1936); *Marie Minor Sanborn*, 33 B.T.A. 1120 (1936).

⁸⁵ *Jesse Lee Edwards*, 22 T.C. 65 (1954); *C. C. Rouse*, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947). Also see *Bourke, Divorce and the Third Party in Interest*, 34 Texas L. Rev. 722 (1956).

is to be paid the wife, it may be advisable to make it clear that such excess payment is for her half interest in a certain property or properties to be assigned to the husband, preferably to properties having a high basis, with the rest of the settlement taking the form of an in-kind exchange.

It has been suggested that if an unfair agreement is reached so that the wife receives less than a full one-half of the value of the community property, the husband may have taxable income.⁹⁶ Presumably this would be subject to normal income and not capital gains tax. It is submitted that this is not the rule. If the husband has been guilty of misrepresentation the wife may set aside the agreement and obtain a fair division. Consequently, any supposed benefit that he may have obtained in the bargaining is subject to an equivalent claim in favor of the wife. More importantly, settlement agreements are generally reached only after considerable bargaining in which both parties are represented by counsel. The arm's length bargain they strike should not be subject to second guessing on the part of the Treasury Department. In addition, these agreements are usually approved by the divorce court as being fair and equitable and such decrees in an adversary proceeding are generally binding on third parties, including the Treasury. At the least the court's finding will be presumptively correct.⁹⁷ Moreover, the cases holding that these partitions are tax-free carry with them the concept of no gain or loss even though one of the spouses may have gotten the better of the bargain.⁹⁸

The tax basis of property following a property settlement presents difficult problems, many of which are as yet unanswered.⁹⁹ Before the divorce each spouse had a half interest in each property and this half interest had a particular cost basis for gain, loss, depreciation and depletion purposes. If the settlement involves a purchase and sale of all or a particular property, a gain or loss is recognized and a new basis established as to the half purchased. But to the extent a nontaxable exchange occurs, a shift of basis

⁹⁶ Bourke, *supra* note 95, at 731.

⁹⁷ Ann Y. Oliver, 8 T.C.M. 403, 430 (1949).

⁹⁸ See note 93, *supra*. It may be added that no revenue loss is involved in this rule. Basis remains unchanged and a subsequent disposition of the divided property at a profit will result in the same tax to the government, whether the property is sold by husband or wife. Moreover, to assert a gain to one spouse will create an equivalent loss to the other.

⁹⁹ Bourke, *supra* note 95. In *C. C. Rouse*, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947), where a sale and not a partition was held to have been made, the price paid to the wife and not the community cost was held to be the basis. It is submitted that half of the community cost plus the price paid the wife for her half should have been the rule. In *Ann Y. Oliver*, 8 T.C.M. 403, 430 (1949), where an exchange of property occurred, the Commissioner sought to limit the basis to half of the community

is required.¹⁰⁰ While the rules are unsettled, the following principles seem sound: If a half interest in a particular property is exchanged for a half interest in another identified property, the property received would have as its basis one-half of the spouse's original cost plus one-half of the basis in the property given in the exchange. Thus if Blackacre is exchanged for Whiteacre, Whiteacre will have as its new basis, one-half of its cost plus one-half of the cost of Blackacre, and vice versa. If a hundred shares of X stock are exchanged for a hundred shares of Y stock, Y stock's new basis is one-half of its cost plus one-half of the cost of X stock. This substitution of basis will apply only if there is a clear exchange of one property for another.

Where there is no identifiable exchange of particular properties, a reallocation of over-all basis must be made. Thus if one group of properties is assigned to the wife and another group to the husband, each group of properties will retain as a part of its basis one-half of the cost of those particular properties. In addition, the aggregate of one-half of the bases of properties given in exchange will then be apportioned among the properties received in the exchange, this apportionment to be made in relation to the then relative values of the properties so received. Where one spouse receives more than half of the community cash on hand, the excess would reduce the recipient's over-all basis to be so reapportioned, and the spouse giving up cash would have an increase in his over-all basis. Similarly, an equal division of community debts would not affect basis. But if one spouse assumes more than one-half of the community debts, that spouse would have an increase in over-all basis and the spouse who is relieved of debt would have a decrease in over-all basis, the adjustment again to be made in the bases of all properties taken in the exchange on the basis of relative values. Compare sections 733, 752, Internal Revenue Code of 1954.

In arriving at a property settlement agreement, the effect of the division in terms of basis should be considered. The acceptance of a low basis property could carry with it a tax charge on its ultimate disposition, which charge may have a material bearing on its actual value.

cost, contending that the husband paid nothing and did not acquire the wife's basis in the settlement agreement. The Tax Court rejected the Commissioner's contention, noting that the effect of the government's position when applied to all property in the partition would be to reduce the basis of all of it by one-half and thereby prevent either party from ever recovering the cost to the community. Apparently, the court allowed the original community cost in absence of a showing of the basis of other property given in the exchange.

¹⁰⁰ Cf. Int. Rev. Code of 1939, § 113(a)(6); Int. Rev. Code of 1954, § 1031(d).

One final point which is often overlooked in the drafting of settlement agreements is the matter of income taxes for the year in which the divorce occurs. Following the divorce the spouses will each file a separate return for the year. In these returns each must report one-half of the community income for the period January 1 to the date of the divorce plus the taxpayer's separate income for the balance of the year. Each spouse's liability for tax on the community income should be recognized and provided for in the agreement. Provision should be made for the husband to supply the divorced wife with the information necessary for her to report her share of this community income; the agreement should be clear as to who will pay the tax on such income as well as any deficiency in income tax for this and prior years. If the property including cash has been equally divided, the wife will assume all taxes on her share. But if the agreement is that the husband will pay all income taxes to the date of the divorce as well as all deficiencies for prior years, it should be so stated and a formula inserted for the apportionment of the current year's taxes. This would be to the effect that the husband will pay that proportion of the wife's taxes for the year in the ratio that her half of the community income bears to her entire income for the year.¹⁰¹ If joint returns have been filed in prior years the spouses are jointly and severally liable for any deficiency in tax. Consequently the settlement agreement, as between the spouses, should provide for the sharing of any such liability and should also provide for the sharing of any expense in connection with contesting a deficiency. One of the spouses, usually the husband, is given authority to enter into binding settlement agreements with the taxing authorities. If a divorce is imminent, separate income tax returns for the year or years prior to divorce may be preferred over the joint return.

10. SOME TAX PROBLEMS IN THE ADMINISTRATION OF A COMMUNITY ESTATE

Our community law gives rise to some unique tax problems in the administration of a community estate following the death of one of the spouses. A few of these may be noted.

In Texas when a spouse dies his estate may be administered in one of several ways. First, the survivor may qualify as community survivor under the community survivorship statutes, which have been recently amended. These statutes and the procedure there-

¹⁰¹ Bourke, *supra* note 95.

under have been fully treated elsewhere and need not be reviewed here.¹⁰² If the spouse dies intestate, the surviving spouse may qualify as administrator under the new Texas Probate Code, in which case bond is required and administration is had under the supervision of the court.¹⁰³ More frequently, the decedent will have left a will naming an independent executor without bond. In such case, the independent executor is appointed by the court at the time of the probate of the will and, except for the filing of an inventory, appraisement and lists of claims, he acts without court administration of any kind. The independent executor has all of the powers of a court-supervised executor. In estate planning in Texas, one of the first recommendations is the preparation of wills for both spouses in each of which independent executors without bond are named.

A. Income During Administration

When the independent executor qualifies, he acts in a two-fold capacity. As executor it is his duty to collect the decedent's share of the community estate; to pay the decedent's half of the community debts; to pay the decedent's federal estate tax; to collect for the State of Texas any inheritance tax imposed on the decedent's legatees; and to administer the residue under the decedent's will. However, he is also under the duty to take and hold the surviving spouse's share of the community estate and therefrom to pay the survivor's share of all community debts and to remit the residue to the survivor. In this latter capacity he acts as a statutory trustee for the survivor and the survivor's creditors.

This dual capacity raises the tax question of, how is income received by the executor during the period of administration to be rendered for federal income taxation? Here the law is still somewhat unsettled.¹⁰⁴ In the *Barbour* case¹⁰⁵ the Fifth Circuit held that during the period of administration the executor as statutory trustee was the owner of the surviving wife's share of the community and consequently the surviving *wife* could not be taxed on a gain derived from the executor's sale of her community property. The case left open the question of whether the executor should file a

¹⁰² Huie, *The Powers and Liability of a Qualified Community Survivor*, 15 *Dallas Bar Speaks* 275 (1952).

¹⁰³ See generally, Haddaway, *Community Property in the Administration of Estates*, 33 *Texas L. Rev.* 1012 (1955); Huie, *Changes Made by the Probate Code in the Administration of Community Property*, 34 *Texas L. Rev.* 700 (1956); Woodward, *Independent Administration under the New Texas Probate Code*, 34 *Texas L. Rev.* 687 (1956).

¹⁰⁴ 34 *Texas L. Rev.* 653 (1956).

¹⁰⁵ *Barbour v. Commissioner*, 89 F.2d 474 (5th Cir. 1937).

separate fiduciary return reporting as trustee for her the income from her half of the property. Later the Tax Court held that a separate fiduciary return was not permissible.¹⁰⁶

In 1950, the Fifth Circuit held that a surviving *husband* could include in his return his share of the community income, because the Texas administration statutes give the wife's executors less control than is given the husband's executors.¹⁰⁷ Finally, in 1955, the Fifth Circuit in the *Sneed* case,¹⁰⁸ involving a surviving wife, held that the surviving wife was taxable during the period of administration on the income from her half of the community. However, the decision cannot be said to settle the question since one of the three judges dissented and each of the other two judges wrote separate opinions, one judge wished to reverse the *Barbour* case and the other to distinguish that case. In this state of uncertainty, some executors continue to follow the *Barbour* decision, others the *Sneed* case.¹⁰⁹ The Revenue Service undertakes to apply the *Sneed* rule.

In other community jurisdictions, the *Sneed* rule applies. In a Louisiana case,¹¹⁰ the Fifth Circuit held the survivor chargeable on half the income during the administration period, distinguishing the *Barbour* case on the ground that the Louisiana law differed from that of Texas. The Ninth Circuit first followed the *Barbour* case,¹¹¹ then qualified it,¹¹² and finally reversed its first decision,¹¹³ so that the *Sneed* rule now applies in the states of Louisiana, Washington and California.

It is believed that the *Sneed* result is correct, if not its reasoning. Since the executor in Texas is in possession of both halves of the community property during the period of administration, he has the primary duty of accounting to the federal authority for any income received by him. While he acts in a two-fold capacity, that of a statutory trustee for the survivor and representative of the decedent, he is not administering two separate estates but undivided interests in a single estate, with the statutory duty of collecting all of the community and out of it paying all community debts and then distributing half the residue to the wife and the other half, after taxes, to the testators' legatees. In his capacity as executor, charged with these duties as to the property in his hands, a single

¹⁰⁶ *Clara Wilson*, 2 T.C.M. 946 (1943).

¹⁰⁷ *Blackburn v. Commissioner*, 180 F.2d 952 (5th Cir. 1950).

¹⁰⁸ *Sneed v. Commissioner*, 220 F.2d 313 (5th Cir. 1955).

¹⁰⁹ See 34 Texas L. Rev. 653 (1956).

¹¹⁰ *Henderson v. Commissioner*, 155 F.2d 310 (5th Cir. 1946).

¹¹¹ *Commissioner v. Larson*, 131 F.2d 85 (9th Cir. 1942) (Wash.).

¹¹² *Bishop v. Commissioner*, 152 F.2d 389 (9th Cir. 1945) (Cal.).

¹¹³ *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954).

fiduciary return seems to be required. However, with respect to that portion of the property representing the survivor's share, his duties are limited. As to that half of the income, he can do three things only—pay it currently to the survivor, in which event it would be taxable to the survivor; or apply the income to the payment of community debts, in which event half would be currently taxable to the survivor since it would then be in satisfaction of the survivor's legal obligations; or accumulate it for future distribution to the survivor. In this third case, the right to accumulate is solely for the purpose of satisfying unpaid community obligations. No part of the half so accumulated can be used to pay the decedent's taxes, except with the survivor's consent. If the income is not needed to pay debts, the executor can be forced to distribute all income and the survivor's property as well. If the executor retains the survivor's share of the income he must credit the survivor's account with this amount and make eventual distribution.

Under the federal taxing statutes, income received by an executor during the period of administration which is "property paid or credited"¹¹⁴ to any beneficiary is deductible by the executor on the fiduciary return and the amount so "paid or credited" is taxable to the beneficiary.¹¹⁵ Under these statutes and under the *Sneed* case, it is believed that the proper procedure is for the executor to file a single fiduciary return during the administration of the estate reporting all income received by him. Whether he distributes the survivor's share or uses it to pay the survivor's share of community debts or withholds it, crediting it to the survivor's account for future distribution, he should take a deduction on his return for the survivor's share and the survivor should report this full share on his or her own income tax return.

B. Funeral and Administration Expenses

In Texas the entire amount of funeral expenses of a deceased spouse is deducted from the decedent's half of the community property.¹¹⁶ However, the Tax Court has held that only one-half of the administration expenses, including executor's, attorney's and accounting fees, is deductible in computing the estate tax on the decedent's share of the community.¹¹⁷ This decision was based on

¹¹⁴ Int. Rev. Code of 1954, § 661(a)(2).

¹¹⁵ Int. Rev. Code of 1954, § 662(a)(2).

¹¹⁶ *Blair v. Stewart*, 49 F.2d 257 (5th Cir. 1931), cert. denied, 284 U.S. 658 (1931). This is also the rule in Idaho, *Estate of Lee v. Commissioner*, 11 T.C. 141 (1948) (Acq.), while in Washington only one-half is deductible, *Estate of Lang v. Commissioner*, 97 F.2d 867 (9th Cir. 1938); *Pacific Nat'l Bank*, 40 B.T.A. 128 (1939) (Acq.).

¹¹⁷ *Estate of Schuhmacher*, 8 T.C. 453 (1947). This was also held to be the rule in the case of an Idaho community estate, *Estate of Lee*, 11 T.C. 141 (1948).

the *Barbour* case, *supra*, and on the fact that under the Texas statutes the executor, during the period of administration, is holding both halves of the community property for the purpose of paying community debts. Accordingly, half of the expense of administering the combined estate is deemed chargeable to the surviving spouse.

These two rules are currently applied by the Revenue Service and are generally followed by executors in the administration of community estates. The result of the second rule is that half of the administration expenses are chargeable to the surviving spouse in the final accounting and the surviving spouse receives a corresponding non-business expense deduction on his or her income tax return.¹¹⁸ The estate has the election of taking its half either as an estate or as an income tax deduction.¹¹⁹

From a tax point of view this treatment of administration expense works to the advantage of the family. The income tax deduction to the surviving spouse is generally more beneficial than the estate tax deduction since income tax rates are usually higher than the estate tax rate. Moreover, if the survivor pays half of these costs, the survivor's estate is correspondingly reduced, resulting in lower estate taxes upon the survivor's death. It is undoubtedly because of these considerations that this treatment of administration expenses has received general acceptance. However, this treatment is open to question and in an appropriate case the appellate court may reach a different result. The federal district court in Louisiana has held that since the surviving wife has a full vested interest in her half of the community, no part of the administration expenses is chargeable to her and accordingly all of such expenses are deductible in the deceased husband's estate tax return.¹²⁰

Perhaps a better rule would be to fairly apportion these expenses between the estate and the surviving spouse on the basis of the time and effort expended on behalf of each estate. The services of the executor, the attorneys and accountants in seeing that the debts are paid and in getting half of the community into the hands of the surviving spouse are of benefit to the survivor's estate and some portion of these expenses may be equitably chargeable to such survivor. But a greater part of the time and effort of the executors and the attorneys is spent in behalf of the decedent's legatees in the

¹¹⁸ Int. Rev. Code of 1954, § 212.

¹¹⁹ Int. Rev. Code of 1954, § 642(g); Rev. Rul. 55-524, 1955-2 Cum. Bull. 535; Rev. Rul. 55-190, 1955-1 Cum. Bull. 275; I.T. 4048, 1951-1 Cum. Bull. 39.

¹²⁰ *Vaccaro v. United States*, 55 F. Supp. 932 (E.D. La. 1944).

probate of the will; the filing of the inventory; in obtaining appraisals of the decedent's estate for tax return purposes; in the preparation and filing of estate and inheritance tax returns; in controversies with the taxing officials; and in the distribution of the decedent's estate in accordance with the will. Thus in terms of time and effort which are the basis of the fees charged, much more is devoted to the decedent's half than the surviving spouse's half of the community. Accordingly, it would seem that some different allocation based on time and effort would be more equitable. In the final accounting the surviving spouse should be charged with only a portion of the administration expenses and the tax treatment should follow this accounting. It may be noted that the Ninth Circuit has held that despite the common practice in California of generally dividing administration expenses between the two estates, the cost of litigating the estate tax liability must be borne by the decedent's estate and accordingly all such expenses of litigation are deductible on the estate tax return.¹²¹

C. Basis

Under section 113 (a) (5) of the 1939 Code all property passing from a decedent receives as a basis for gain, loss, depreciation and depletion the value of such property at the decedent's death. This is true with respect to all of the decedent's property, even that passing to the surviving spouse and with respect to which a marital deduction is allowed. As a part of the equalization bill of 1948, section 113 (a) (5) of the 1939 Code was amended so as to extend these basis provisions to the surviving spouse's interest in community property; this amendment was carried over into the 1954 Internal Revenue Code.¹²² In the recent inflationary period this statute has been extremely beneficial to surviving spouses in the community property states.

This statute sometimes places competing duties on the executor of a community estate. In the interest of the decedent's residuary legatees the executor seeks to keep the values as low as possible so as to minimize the estate taxes; but from an income tax point of view it may be to the surviving spouse's interest to have higher values placed on the property in order to obtain the higher basis for gain, loss, depreciation and depletion purposes. In dealing with the estate tax department the tax-conscious executor must keep this statute in mind and seek to resolve his conflicting responsibilities.

¹²¹ *Estate of Lang v. Commissioner*, 97 F.2d 867 (9th Cir. 1938).

¹²² Int. Rev. Code of 1954, § 1014(b) (6).

Usually with respect to properties that are likely to be sold or to properties of an inventory nature such as cattle or to depreciable or depletable properties, he will accede to a higher estate tax valuation, but with respect to other properties he strives to keep the values as low as possible. As to properties that are sold following death, the higher valuation increases the estate tax on half of the property but the higher value produces a higher basis and a correspondingly lower capital gain tax on both halves of the property. Except in the very large estate, the capital gain tax on the two halves is greater than the estate tax on half. And as to the inventory on depreciable types of property, the reduction in normal income tax on both halves is substantially greater than the estate tax on half.

D. Distributions and Partitions of a Community Estate

Following the payment of the estate and inheritance taxes, the decedent's estate, distributable to the legatees under the will, is, because of the taxes, less than the estate distributable to the surviving spouse. Moreover, frequently the executor, with the surviving spouse's consent, may have used some of the survivor's funds with which to pay the decedent's taxes and must account to the survivor for such use. The result is that a disproportionate distribution must be made in favor of the surviving spouse and the accounting must be made in properties. Frequently, in the final accounting, the surviving spouse may accept properties of one kind and the decedent's legatees properties of another kind. For a time it was thought that such distributions of properties of unlike kind involved taxable exchanges as between the surviving spouse and the beneficiaries under the will. However, the Tax Court has held that such in-kind partitions and divisions are not commercial transactions to which the exchange provisions of the taxing statutes are directed,¹²³ and this decision represents the accepted policy of the Treasury Department today.

Moreover, since the tax basis of the surviving spouse's interest in the community is stepped-up at death, an exchange, though taxable, would generally produce no gain if the property received on the exchange equals the basis of that given in exchange.

In the final distribution of the community estate, the possibilities of further tax planning should be considered, taking future income and estate taxes into account. If the decedent has left his share of the community to the children, the surviving spouse might be well

¹²³ M. L. Long, 35 B.T.A. 95, 98 (1936); cf. Marie Minor Sanborn, 33 B.T.A. 1120 (1936).

advised to take the more conservative, low income type of property and divide the higher yield properties among the children to the end that the family may have a reduction in future income taxes by spreading the larger income among several taxpayers. Likewise, properties having enhancement possibilities could be distributed to the children while the more conservative and less speculative properties would be taken by the surviving spouse so as to remove these incremental values from later estate taxation at the surviving spouse's death.

11. LIFE INSURANCE

Many interesting problems arise in the treatment of life insurance under our community laws.¹²⁴ The life insurance policy is a contract between the applicant and the insurance company. Under the contract the insurance company is obligated to pay the cash surrender value to the insured or other owner. At death the rights of the beneficiary become fully vested and the company is, by contract, obligated to pay the proceeds to such beneficiary. The payee may be the insured's estate, or his spouse, or a third party. Where the policy is taken out during marriage and paid for with community funds, death or divorce may bring about competing claims between the payee under the policy and the spouse whose funds have entered into the purchase of the policy.

While the cases generally have regarded the insurance policies and the avails thereof as but another species of community property to be governed by the usual community property rules,¹²⁵ dicta in some of the cases have rather suggested that life insurance is *sui juris*, that policies of life insurance are not property in the community property sense, and that the life insurance laws are a gloss upon the community laws; and that special rules of the insurance law govern the disposition of the contract rights under the policy.¹²⁶

¹²⁴ See Huie, Community Property Laws as Applied to Life Insurance, 17 Texas L. Rev. 121 (1939); 18 Texas L. Rev. 121 (1940).

¹²⁵ Kemp v. Metropolitan Life Ins. Co., 205 F.2d 857 (5th Cir. 1953) (wife can recover half of proceeds payable to husband's sisters as constructive fraud on community); Womack v. Womack, 141 Tex. 299, 172 S.W.2d 307 (1943) (cash surrender value of policies on divorce is community); Blackmon v. Hansen, 140 Tex. 536, 169 S.W.2d 962 (1943) (only half of proceeds of insurance bought with community funds subject to Texas inheritance tax); Thompson v. Calvert, 301 S.W.2d 496 (Tex. Civ. App. 1957) (one-half of cash values of life insurance on husband's life subject to inheritance tax at wife's death); Aaron v. Aaron, 173 S.W.2d 310 (Tex. Civ. App. 1945) error ref. w.o.m. (wife had half interest in policy proceeds payable to husband's mother in fraud of wife's community rights); Martin v. Moran, 32 S.W. 904 (Tex. Civ. App. 1895) (proceeds payable to husband's estate at death are community).

¹²⁶ Warthan v. Haynes, —Tex.—, 288 S.W.2d 481 (1956); Sherman v. Roe, 153 Tex. 1, 262 S.W.2d 393 (1953); Volunteer State Life Ins. Co. v. Hardin, 145 Tex. 245, 197 S.W.2d 105 (1946). These later decisions, particularly the Warthan case, evidencing a

The doubt raised by this dicta has, it is believed, been removed by the Texas legislature in the 1957 session. There the definition of the word "property" was amended specifically to include "life insurance policies and the effects thereof."¹²⁷ Thus as "property" life insurance and the avails thereof acquired during marriage would, under our statutes, be regarded as community property. As community property, the usual community property rules would apply: the insured would own the policy, not in his own right, but for and on behalf of the community. If the husband were the insured and owner of the policy, he possesses the incidents of ownership as manager of the community and as to one-half of these rights acts as agent for the wife. If the policy is surrendered the cash surrender value would be community. If a loan is made against the policy the proceeds are community. At divorce each spouse would be entitled to one-half of the cash surrender value of the policy.¹²⁸ If the insured's estate, as beneficiary, collects the proceeds at death, the surviving spouse is entitled to one-half, and only half of the proceeds is administered as a part of the decedent's estate.¹²⁹ If the surviving spouse is the beneficiary, he or she takes one-half of the proceeds as his or her interest in the community property and the other half as a "gift or devise" from the insured. If a third party is named beneficiary, the usual rules relating to gifts of community property obtain. In Texas, unlike the civil law in some jurisdictions, the husband as manager of the community may make limited gifts of community property. Such gifts, however, are subject to the rule that the transfer must not be in fraud of the wife's community rights. Here the rule is not an absolute one, but relative, being largely a matter of degree and substantiality. If the gift is large in relation to the size of the community, and particularly, if made to one not an intimate member of the family group, the wife may, as to one-half, succeed in having it set aside.¹³⁰ These rules would apply to gifts of life insurance. If the policy is assigned outright to a child or other third party and is not in fraud of the wife's rights, husband and wife

degree of confusion on the part of the Texas Supreme Court, created considerable uncertainty in this area of the law. See Stephens, *Life Insurance and Community Property in Texas—Revisited*, 10 Sw. L.J. 343 (1956).

¹²⁷ Vernon's Tex. Sess. Laws 1957, 55th Leg., Reg. Sess. (H.B. 900) 1228: "'Property' includes real and personal property, and life insurance policies and the effects thereof." (Emphasis added.) The amendment was specifically directed at the Warthan case. As to the effect of this amendment see Swift, House Bill 900 and Your Life Insurance Policy, Vol. 20 Texas Bar Journal No. 11 P. 691.

¹²⁸ *Womack v. Womack*, 141 Tex. 299, 172 S.W.2d 307 (1943).

¹²⁹ *Martin v. Moran*, 32 S.W. 904 (Tex. Civ. App. 1895).

¹³⁰ *Kemp v. Metropolitan Life Ins. Co.*, 205 F.2d 857 (5th Cir. 1953); *Aaron v. Aaron*, 173 S.W.2d 310 (Tex. Civ. App. 1945) error ref. w.o.m.

each have made a gift of one-half. If a third party is named beneficiary and the right to change beneficiaries is retained, the gift is incomplete until the death of the insured, at which time the rights of the beneficiary become vested and the spouses at that time have completed their gift. But if either the assignment of the policy or the beneficiary designation is in fraud of the wife's rights, she may recover half of the policy proceeds.

The community property rules will be applied in the taxation of life insurance. Prior to 1954, life insurance was taxed to the insured if he possessed any of the incidents of ownership in the policy or if and to the extent that he paid premiums thereon. In the 1954 Code the premium payment test was eliminated and the insured is taxed only to the extent that he possesses any of the incidents of ownership.¹³¹ As to policies taken out during marriage and paid for with community funds, these incidents of ownership belong to the community and the following tax rules apply.¹³²

If the husband is the insured and nominal owner of the policy and his wife predeceases him, one-half of the cash surrender value will be included in the wife's estate and subject to estate tax.

If the wife is the insured and nominal owner and the husband predeceases her, one-half of the cash surrender value will be taxed to his estate unless it is clearly shown that he intended to make a gift of his half interest in the policy and in the premiums to his wife.

If at the death of the insured, the insured is the nominal owner and his estate or surviving spouse is beneficiary, only half of the proceeds is subject to estate tax.

If at the death of the insured, the surviving wife is both nominal owner and beneficiary and it is shown that the insured intended to give his wife his interest in the policy and in all premium payments, there would be no estate tax, but the intent to make these gifts must clearly appear. In absence of this showing, half the proceeds will be taxed.

If the policy is assigned absolutely to a son or other third person, husband and wife each pay gift taxes on one-half of the policy values, and if premiums are thereafter paid with community funds, each spouse will have made a taxable gift (to the extent that the

¹³¹ Int. Rev. Code of 1954, § 2042.

¹³² U.S. Treas. Reg. 105, §§ 81.26, 81.27 (1942), as amended by T.D. 5699, 1949-1 CB 181, 189 and see *Lang's Estate v. Commissioner*, 304 U.S. 264 (1938); Swift, note 127 *supra*.

gift exceeds the annual exclusions and exemptions) of one-half of such premiums. There would be no estate tax.

If the son or other third person is simply named beneficiary, with the nominal ownership including the right to change beneficiaries retained in the insured, the beneficiary's rights do not become vested until the death of the insured, and there is no gift tax on premiums paid because the beneficiary might be changed to the insured's estate or some one else or the policy might be surrendered. But at the insured's death, the beneficiary's rights become vested and the gift to him, which theretofore was revocable, becomes complete. At that time the spouses have made a complete transfer of community property with the result that half of the policy proceeds are subject to estate taxes in the insured's estate and the other half of the proceeds are subject to gift taxes by the surviving spouse.

If the surviving wife is named beneficiary and under one of the settlement options the wife is paid a monthly sum for her life with ten or twenty years guaranteed, at the husband's death only one-half of the face value will be included in his estate, the wife having purchased the other half with her half of the community funds. If the wife should then die within the ten or twenty year guaranteed period and the unpaid balance is paid to the secondary beneficiary named in the policy, one-half of such balance, representing the husband's half, passes to the secondary beneficiary from the husband free of a second tax; but as to the other half passing to the secondary beneficiary, representing the wife's share, there will be an estate tax at her death since in the selection of this mode of settlement the wife at her husband's death is deemed to have made a transfer under section 2036 under which she has retained the use and enjoyment of her half of the policy values for her own life.

The law is unsettled as to the treatment to be given a life insurance policy taken out before marriage and maintained after marriage with community funds. The federal statute taxes the insured if, at his death, he possesses "any of the incidents of ownership." The possession of these rights as manager of the community would not subject the husband, as manager, to tax. If the community possesses these rights, the wife would possess half and the husband half. If, however, as to a policy taken out before marriage and maintained thereafter with community funds, the husband possesses the incidents of ownership in his separate, as distinguished from his managerial, capacity, the whole would be taxed.

What, then, is the ownership, under Texas law, of a policy taken

out before marriage and maintained thereafter with community funds? Are the incidents of ownership in the husband in his community or separate capacity, or is the ownership divided?

There are three possibilities: (1) that the insurance policy is a contract, and therefore a property right. Since it was taken out before marriage it was, and remains, separate property. Under this view, the proceeds would all be separate and the community estate would be entitled to reimbursement for all premiums paid after marriage; (2) that like the slave in *Love v. Robertson, supra*, the insurance was acquired in part with separate and in part with community funds and the ownership is split in the ratio that the funds contributed by each estate bears to the total premiums paid; this was the old Treasury rule under the premium payment test; (3) that the insurance policy was contributed to the community partnership and became community, with the result that all proceeds are community, subject to a reimbursement to the separate estate of the cash surrender value of the policy as of the date of marriage.

Of the three possibilities, the second or third appears to be the more reasonable, and of these two, our preference would be for the third. Life insurance is an annual payment affair. It involves an element of savings together with the element of protection. The payment of each annual premium is necessary to continue the yearly protection element in the contract. Each year the community, through annual premiums, bought two things, a year's protection, plus an increase in the cash value. It would seem that the proper rule would be to apply the reimbursement rule; to treat the policy as having been contributed to the marital partnership; to treat all the proceeds as community, since these proceeds were made possible by the payment by the community of the last year's premium; to ignore the amount of premiums paid prior to marriage in so far as such premarital premium payments had paid for the years of premarital insurance protection; but to allow reimbursement to the separate estate for the amount of the cash surrender value of the policy (the savings element) at the date of the marriage.¹³³

¹³³ Apparently, the Texas law is yet unsettled and no case has decided the federal tax question under the 1954 Code. The closest Texas case is *Aaron v. Aaron*, 173 S.W.2d 310 (Tex. Civ. App. 1943) error ref. w.o.m. There the husband had taken out policies before marriage and after marriage had paid premiums out of community funds. Following certain marital difficulties, the insured, for purposes of defrauding his wife, named his mother beneficiary in the policies. The court held that the decedent had given his separately owned policies to the community and he had no right, by gift in fraud of the wife's rights, to give her portion of the policies to his mother; that the policies were community property; and that the wife was entitled to recover one-half of the proceeds. To the same effect is *Kemp v. Metropolitan Life Ins. Co.*, 205 F.2d 857 (5th Cir. 1953). In light of *Tittle v. Tittle*, 148 Tex. 102, 220 S.W.2d 637 (1949), it may be questioned

12. CONSTRUCTIVE TRUSTS

Rules of constructive and resulting trusts have found their way to a surprising degree into the Texas community property law, although these rules are of common law rather than civil law origin. Thus, if the wife's separate funds are used to purchase land in the husband's name, the law will establish a resulting trust in favor of the wife as her separate property,¹³⁴ unless it be shown by the evidence that a gift or a loan was intended.¹³⁵ However, this is not the place to discuss these interesting developments. Only one typical situation involving constructive trusts will be mentioned since that situation occurs not infrequently in the tax practice and its discussion will bear upon a point to be discussed later.

The situation is one in which the wife predeceases her husband, leaving minor children and no will. The community property stands in the husband's name, so he sees no reason to take out administration on his wife's estate and does not qualify as community survivor, and makes no accounting to the children. Years go by; he supports and educates his children; and he prospers and dies. What are his children's rights; and what are the estate tax consequences?

Here the law is clear. At the death of the wife intestate, her half of the community property passed to her minor children. It was the duty of the father to make a timely accounting to the children of their share of the community estate. Having failed in this duty, the law will construct a trust in favor of the children. It makes no difference that the father acted innocently and in ignorance of the law; he should have known the law and has been guilty of constructive, if not actual, fraud. This means that under accepted trust principles, the children may recover either the value of the mother's estate, with interest for its use, or they may pursue the assets in the father's hands and recover these assets. If assets have been sold or disposed of, they may impress a trust on the proceeds, and if these have been used to acquire other assets, the trust follows such assets. If, over a period of years, exact tracing is impossible, the children will be able to recover one-half of the properties held by the father at his death, even though he may have mingled personal

whether the two decisions were right in finding a gift of the policies to the community in the first instance. However the decisions that the proceeds were community seem sound. Had reimbursement been allowed for the cash values at the time of the marriage, a correct result would have been achieved and the Tittle case reconciled.

¹³⁴ *Evans v. Welborne*, 74 Tex. 530, 12 S.W. 230 (1889); *Matador Land & Cattle Co. v. Cooper*, 87 S.W. 235 (Tex. Civ. App. 1905).

¹³⁵ *Levy v. Williams*, 50 S.W. 528 (Tex. Civ. App. 1899).

earnings or other separate funds with the common trust fund.¹³⁶ In tax parlance, we have a "family partnership" imposed by law.

The tax consequences are obvious. Only one-half of the estate on hand at the father's death will be subject to estate tax since the children own the other half; and the income during the trust period is taxable one-half to the father and the other half to the children, the proper accounting for which may involve the filing of delinquent returns for the children and claims for refund for the father, in the event that he has paid income tax on the whole.¹³⁷

13. EXTRA-TERRITORIAL APPLICATION OF THE TEXAS COMMUNITY PROPERTY LAW

This topic raises problems in four different situations: (a) spouses possessed of community property change their domicile from Texas to a common law state; (b) spouses move into Texas from a common law state; (c) a Texas domiciliary invests funds in a common law state; and (d) citizens of a common law state invest funds in Texas. To what extent will Texas community property law apply in these situations? The extent of the applicability of our law will affect the estate of the spouses with consequential effect on estate taxes and estate planning.

(a) If Texas citizens change their domicile to New York or some other common law state, our answer is found in the last discussion of constructive trusts. Of course, if identifiable separate properties are carried to the foreign state, they remain separate. If community property is taken to the common law state, that new state will not apply the rules of community property. Community property, as such, is foreign to that state and, as such, will not be recognized. However, the state of the new domicile will take notice of the laws of Texas under which the properties were acquired and will recognize that under the Texas community

¹³⁶ The generally accepted trust principles summarized above have been followed in a number of Texas cases dealing with situations of this kind. *Watley v. Shoults*, 137 S.W.2d 149 (Tex. Civ. App. 1940); *Garcia v. Garcia*, 4 S.W.2d 257 (Tex. Civ. App. 1928); *Spencer v. Pettit*, 268 S.W. 779 (Tex. Civ. App. 1925), 2 S.W.2d 422 (Tex. Civ. App. 1928), 17 S.W.2d 1102 (Tex. Civ. App. 1929); *Hand v. Errington*, 233 S.W. 567 (Tex. Civ. App. 1921), aff'd, 242 S.W. 722 (Tex. Comm. App. 1922); *Pynes v. Pynes*, 225 S.W. 777 (Tex. Civ. App. 1920); *Highsaw v. Head*, 202 S.W. 155 (Tex. Civ. App. 1922); 42 Tex. Jur., Trusts, 740 (1936).

¹³⁷ Of course, laches or limitation may have barred the children's claim, in which event different tax consequences follow. However, laches or limitation will not start to run until the children actually learn of, or through the exercise of reasonable diligence, should have known of, the fraud. Certainly, during minority no such defense would be available. Moreover, the facts will sometimes show that the father is not holding adversely; that he has recognized their interest and has assured them he will account in due course. Under such circumstances, laches or limitation will not apply until he begins to hold adversely.

property laws, the wife had a vested half interest in the properties brought from Texas. The courts would view her as owning one-half as a tenant in common with her husband, and as such tenant in common she could force a partition. If the properties stand in the husband's name, he holds the wife's half in trust for her under a resulting or constructive trust. As the beneficiary of the trust, the wife would have all of the rights of the children of the deceased wife, discussed in the section on constructive trusts, *supra*. She could demand an accounting and impress a trust on all properties thereafter acquired by him with her share of the common fund. If he were to mingle his own separate earnings or properties with the common funds held by him as trustee, she or her heirs could impress a trust on one-half of everything standing in his name. These rules have been recognized in a number of cases arising in other states and should be the rule in any common law state where the question may arise.¹³⁸ Obviously, the estate and income tax results of these rules can be significant.

(b) If spouses from a common law state change their domicile to Texas, Texas will look to the law of their original domicile to determine the character and ownership of properties brought into Texas. If a particular property was separately owned in the foreign state, it remains separate when brought into Texas.¹³⁹ However, once the spouses become domiciled in Texas, they subject themselves to the community property laws of this state and thereafter income earned by them or by their separate properties becomes community, in accordance with the general rules hereinabove discussed. It may be noted that, while the Texas constitution and statutes define community property as all property acquired "after marriage," this means only after a marriage which has become subject to our jurisdiction by a change of domicile. Our laws do not reach back into acquisitions made while the spouses were living in the foreign state and change the character of such previously acquired properties.

(c) The third problem deals with Texas citizens' investing their funds in a foreign state. If community or separate funds are invested in personal property (stocks, bonds and the like) abroad, the law of the Texas domicile would control the ownership of such acquisitions, under the doctrine of *mobilia sequuntur personam*.

¹³⁸ Johnson v. Commissioner, 88 F.2d 952 (8th Cir. 1937); Phillips v. Commissioner, 9 B.T.A. 153 (1927); I.T. 1268, I-1 Cum. Bull. 234 (1922); Depas v. Mayo, 11 Mo. 314 (1848); Edwards v. Edwards, 233 Pac. 477 (Okla. 1925); Barnes v. Spencer, 79 Ore. 205, 153 Pac. 47 (1915); Restatement, Conflict of Laws, § 292 (1934).

¹³⁹ Restatement, Conflict of Laws, § 293 (1934).

If separate funds were used in the acquisition, the property acquired would be separate; if community funds were used to purchase the property, the property would be community. The courts would look to the domicile of the parties and apply the community property law of Texas in determining the ownership of such personal property.¹⁴⁰

If the Texas domiciliaries acquired land in a foreign state, the ownership of the property would be determined by the law of the situs, rather than the law of the Texas domicile. If the foreign state is a common law state, it will not apply community property rules as such. However, the courts in such foreign state will look to the source of the funds used to acquire the land. If community funds are used in the acquisition, the principles discussed under (a), above, would apply. The foreign court would find that the purchase was made with community funds; it would then look to the Texas community property laws and find that the wife has an equal vested interest with the husband in these funds. Then it would apply its own trust and property rules to the acquisition. If title were taken in the husband's name, the court would hold, under its own trust laws, that the husband was a resulting or constructive trustee, holding the wife's half in trust for her.¹⁴¹

If a Texas husband invested his wife's separate funds in land abroad, taking title in his own name, the foreign court, applying its own trust rules, would regard the husband as a trustee, holding the property for the benefit of the wife, unless it were shown that she intended to make her husband a gift or a loan.

Up to this point, we have been discussing only the ownership of the first acquisition abroad and, as stated, this ownership will depend (a) upon whether the property is personalty or realty and (b) upon the source of funds used to make the acquisition. But what about the revenues derived abroad from the foreign investment?

If the income is derived from a foreign investment in personalty, e.g., interest on a New York savings account, such income would clearly be community property, because the property itself as well as the income therefrom is personalty and governed as to ownership by the law of the Texas domicile.

If, however, the investment is in lands in another state, and this land produces rental income, are such rents to be governed by

¹⁴⁰ *Id.* at § 292.

¹⁴¹ *Id.* at § 293. Of course, if separate funds were used in the acquisition, the property would be separately owned under the laws of the foreign jurisdiction.

the laws of the situs or the laws of the domicile? If the rents are derived from lands acquired with community funds, no problem is presented since the rents will be equally owned under either law. But if separate funds are invested in such realty, then the question becomes important since if the law of the situs governs ownership, the rents will be separately owned; whereas, if the law of the domicile controls, the rents will be community, since income from separate property under Texas law belongs to the community.

The law here is unsettled. The Fifth Circuit in the *Skaggs* case¹⁴² has held that under these circumstances the law of the situs controls. In that case, a Texas resident owned, as separate property, lands in California. Under the California laws, income from separate property is separate. On the question of whether the spouses could report the rents as community on separate tax returns, the court held that the ownership of the rents, like the land itself, was to be governed by the law of the situs and that the rents were the husband's separate property under the California law.

It is respectfully submitted that the decision is wrong. While it is undoubtedly true that as a general rule the law of the situs controls the ownership of the land itself, once rentals are paid they are no longer an interest in the land but become personalty and, as such, should be governed by the law of the domicile. Oil in place is real estate in Texas and elsewhere, but once it reaches the surface, it becomes personalty and is no longer real property. So, while the interests in the land and the interests in the lease itself may be realty, once the rentals are received they cease to be an interest in land and become personalty and, for purposes of determining the rights of the wife, should be governed by the law of the domicile.

The civil law concept and the concept of our community property law observe this difference. The land may be separate, and if exchanged for other lands or if sold its separate character carries over to the property or money received on the exchange or sale; however, the rental income is not the same property; it is a different property and being acquired during marriage, is therefore community. The *Skaggs* case strikes at the heart of this basic community property concept.

The Texas Supreme Court has not passed on the question so far as we are aware, so that the tax decision of the Fifth Circuit, in the *Skaggs* case, while entitled to weight, is not the last word. If the case were presented to the Texas Supreme Court, it is believed

¹⁴² *Skaggs v. Commissioner*, 122 F.2d 721 (5th Cir. 1941).

that it would decide otherwise. Certainly, the Court would be inclined to follow the mandate of the Texas constitution and statutes, that all property acquired during marriage except that acquired by gift, devise or descent is community. These rents were not owned before marriage nor were they acquired by gift, devise or descent, and therefore they are not separate property. Our courts have gone far in protecting the community and the wife's rights to income from the separate property of the husband; the community is the favored estate. Unless compelled by some pressing rule of comity, Texas courts would be inclined to follow Texas law and not the law of the situs. While it is necessary that the law of the situs control in matters of title and devolution of title to real property within its own jurisdiction, these reasons are not compelling when applied to rental payments. These more often than not are paid to the owner at the place of his domicile; they will usually be deposited in the domiciliary state; being movables, they are under the control of the lessor and are subject to the jurisdiction of the courts of the domicile and should be governed by the laws of the domicile.

The *Skaggs* rule would permit a husband to defeat, to a large measure, the salutary purpose of our community laws and to deprive the wife of her rightful interest in half of the accumulations of the marriage by the simple expedient of investing his separate funds in real estate abroad. It is to be hoped that when the question arises, our Texas courts and the courts in other states will refuse to follow the *Skaggs* decision and instead apply the Texas law to rents from separate lands located in other states.

(d) This brings us to the fourth problem, that of domiciliaries of other states investing funds in Texas. In increasing numbers, residents of other states are investing funds in oil and other properties in Texas. There seems to be a widespread belief that such investors, even though they retain their foreign domicile, become subject to the Texas community property laws and that such investments create an interest in the wife of one-half of the Texas accumulations. Under the principles outlined above, we believe such is not the case.

If a New York resident buys stocks or other movables with his separate funds, Texas courts would look to the source of such funds and apply the law of New York, since the acquired property and the income therefrom are personalty governed by the laws of the New York domicile. Accordingly, the investment, and the proceeds and income therefrom, all movables, would remain separate. If he invested in oil royalties, the ownership would be governed

by Texas law, but the Texas court would again look to the source of the funds used to acquire the royalty, and finding this to be separate, would hold the royalty to be separate. Income from the royalty would, under Texas law, likewise be separate.¹⁴³ If he invested in an oil lease, the lease likewise would be separate under our law because acquired with separate funds. To the extent that *Norris v. Vaughan*¹⁴⁴ would be applicable, the revenues from such lease would be separate. Rents from Texas real estate should, despite the *Skaggs* decision, be regarded as personalty and not as land, and their ownership should be governed by the law of the domicile and not by the law of Texas. Under New York law, the rents would belong to the owner of the separate land. The same rule should apply to personal earnings in Texas of a foreign domiciliary. Thus, all original investments are separate if acquired with separate funds and all income (even though deemed community under Texas law) would be separate because such are personalty and governed by the law of the foreign domicile. If income from all such sources remains separate, reinvestments of such earnings remain separate. It would only be by tracing separate funds of the wife into Texas holdings that the wife obtains an interest under our law.

While the Texas Supreme Court has not finally established these rules, it is submitted that it should, and will, do so. These rules comport with accepted principles of conflicts of laws. Moreover, in a broader sense, Texas community property laws should not reach out beyond the borders of our state and apply to domiciliaries in other states. Our marital system should extend only to our own citizens—to spouses actually domiciled here. To extend its rules to spouses living in other states will create confusion, uncertainties and complexities. Under the *Skaggs* case, the community rules would extend only to certain Texas accumulations and not to others. It would not apply to the original investments in Texas since they would remain separate if purchased with separate funds. It would not apply to dividends, interest and other forms of income from personalty since they would be governed by the law of the foreign domicile. It would not extend to capital gain on sale of Texas properties since under our law the proceeds remain separate. It would not extend to oil royalties or bonuses, or perhaps receipts from working interests since they, under our law, remain separate. The community rules, under the *Skaggs* decision, would extend only to delay rentals and rents and income from Texas

¹⁴³ See note 33, *supra*.

¹⁴⁴ 152 Tex. 491, 260 S.W.2d 676 (1953).

real property. This, as we have stated, should not be the rule. To hold that only this particular type of income becomes community would extend the principles of marital partnership to one segment only of a foreign investor's operations in Texas, whereas our system is intended to create a marital partnership involving all marital operations. To apply the partnership principle to one type of income only would produce difficult tracing problems, both here and in other states, where such income is mingled with other separate items and the mingled fund invested in other properties, either here or in other states. Legal complications and uncertainties of title would result. The possible complications might operate as a deterrent to the investment of foreign funds in Texas. It is believed that the extension of our community rules to this segment of a foreign investor's income is undesirable and not required by any rule of comity or any principle of conflicts of laws.¹⁴⁵

CONCLUSION

This review of some of the more current community property problems arising in the tax practice shows that in a number of areas the law is still unsettled. Such important questions as the treatment of working interest income, stock dividends, reorganizations, corporate distributions and liquidations, extraordinary dividends, income from limited estates, annuities, reimbursements, life insurance, and investments of Texas funds in other states and foreign funds in Texas, are among questions yet to be resolved. The trend of the law today is in the direction of codification. More and more, important areas of the law are reduced to statutory form. Texas has adopted many of the uniform state laws. The Texas Trust Act supplied an urgent need in the trust field. The legislature has recently adopted the Probate Code, the Corporation Code and the Uniform Limited Partnership Act. It would be a boon to the courts and the bar if our community laws were codified. Such a Community Property Code would compile and revise present statutory provisions and reduce to statutory form the rules which have been painstakingly worked out by the courts over the past hundred

¹⁴⁵ The rule of the Skaggs case could be reduced to an absurdity. Suppose an Arab, with four lawful wives, invests in Texas lands. If the law of the situs is to apply, how would our community law divide the rents between the man and his four wives? Is it not more sensible for the courts to view the rents as personalty, and allow the ownership to be worked out in accordance with Arabic law? It may be noted that the Tenth Circuit, in *Noble v. Commissioner*, 138 F.2d 444 (1943), reached a result different from the Skaggs case, but see *Benjamin H. McElhinney, Jr.*, 17 T.C. 7 (1951), and *Mamie S. Hammonds*, 38 B.T.A. 4 (1938), *aff'd*, 106 F.2d 420 (10th Cir. 1939).

years. And such a code would give us the needed answer to questions yet unanswered, of which those suggested here are but a few. A project of this kind, sponsored by the Texas State Bar, would be a substantial contribution to the jurisprudence of our State.